
DONALD TRUMP
HILLARY CLINTON
BREXIT
CHINA
OIL BUST
DEBT BUBBLE
THE NEXT
BIG
SHORT
A COLLECTION OF LOOMING MARKET RISKS

Contents.

TheoTrade

The Next Big Short

A Collection of Looming Market Risks

Edition V1

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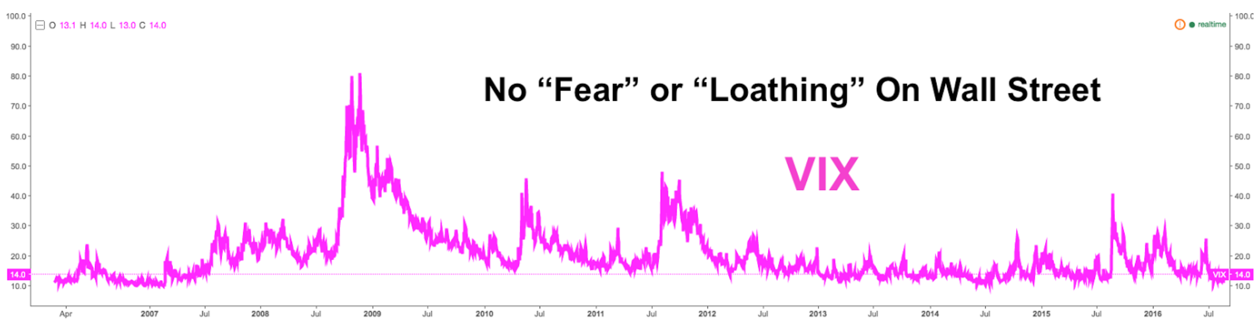
Complacency.

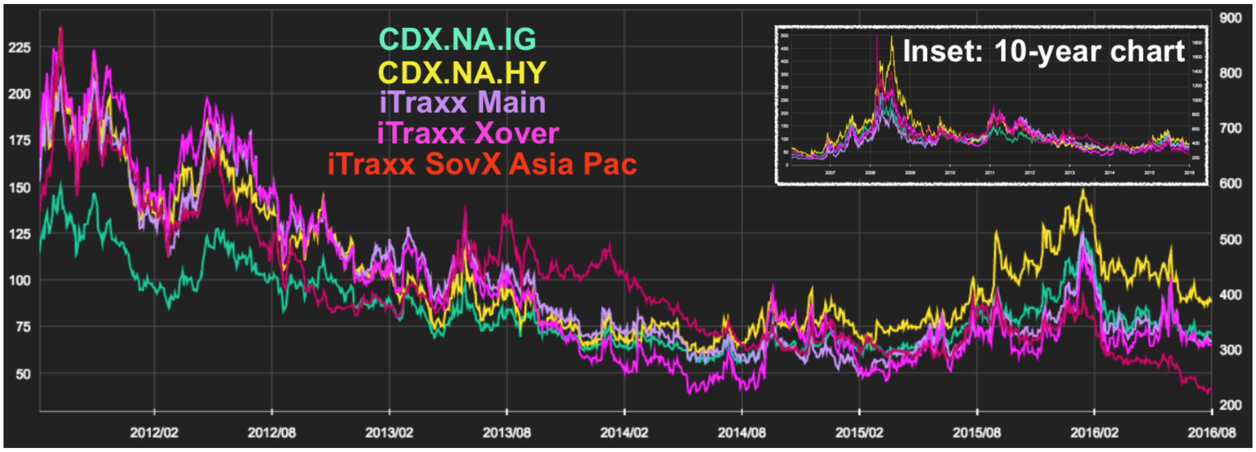
"[It's] not such a bad thing to have a game plan as we round the far turn and begin the long-stretch run to year-end," Bloomberg's Richard Breslow remarked on Wednesday morning.

You know we're living in peculiar times when we have to be reminded that it's a good idea to have a game plan - and as a reminder, "buy the dip" is most assuredly not a game plan even as central banks have ensured its efficacy.

The degree of complacency in markets considering the myriad tail risks on the horizon is truly remarkable. There's the VIX of course, which is floundering down around 14 and at one point in August plunged to an 11-handle:

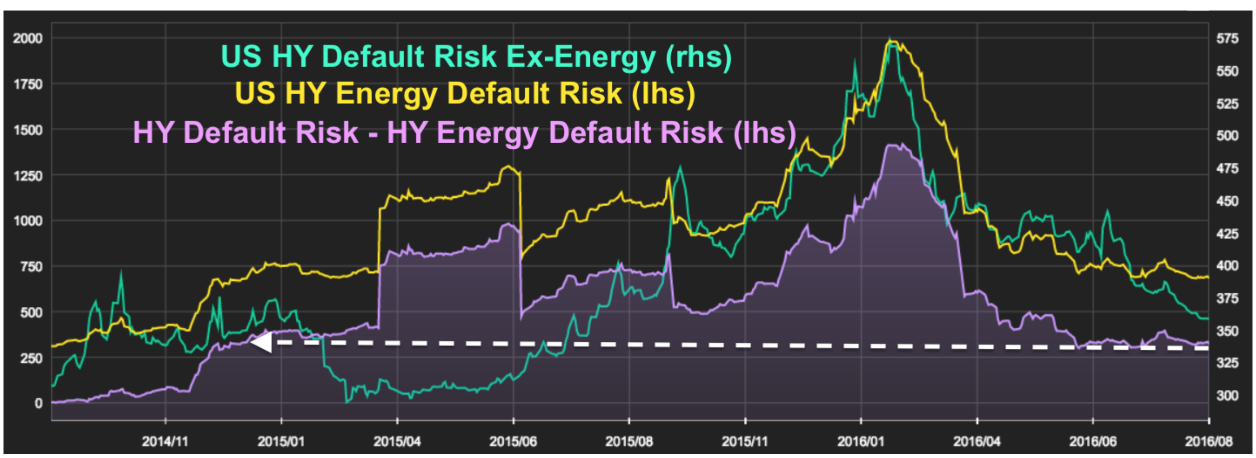


But it's not just the headline "fear gauge" you should be looking at. Have a look at the following chart which you should think of as "default risk" for US investment grade, US high yield, European investment grade, European speculative grade, and Asia Pacific sovereign debt, respectively:

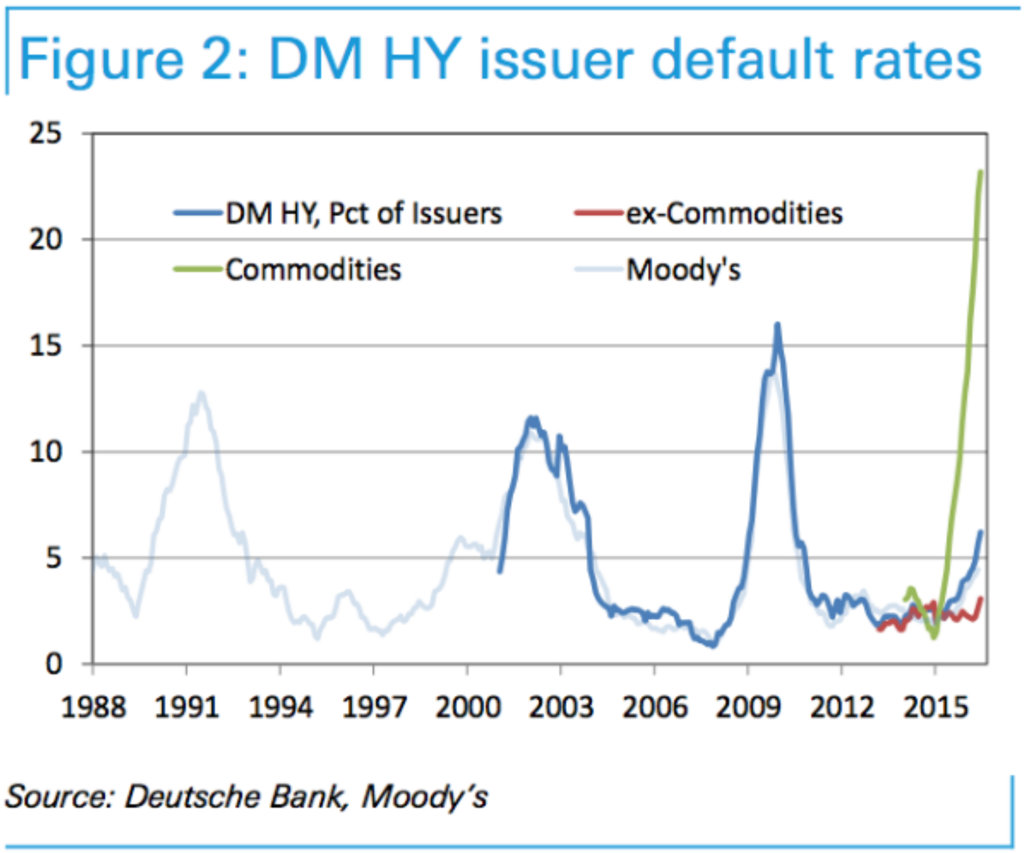


As you can see, with the exception of the spike around the first of the year tied to renewed pressure on the yuan fixing and downward spiralling oil prices, spreads have been on a steady grind lower - especially from a 10-year perspective (inset).

If you want to see just how complacent the market has become, look no further than this chart:



Essentially what you're seeing there is that the market is pricing in the least default risk for US high yield energy relative to US high yield excluding energy since 2011. And yet here's what we've seen in terms of commodities defaults:



(Chart: Deutsche Bank)

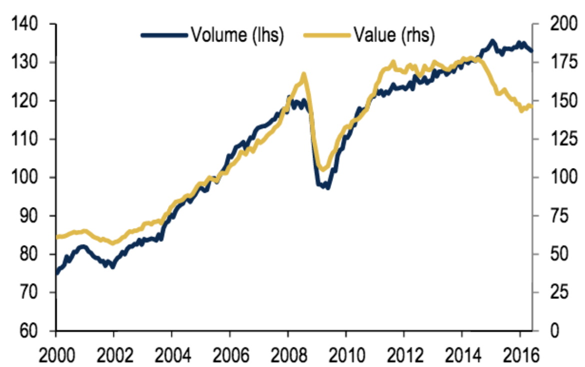
That paints a pretty decent picture of where we stand in terms of complacency. If you need more evidence, well, just look at the S&P.

So is this warranted? That is, what are these "tail risks" we speak of and why should they trump (no pun intended) central bank accommodation? Well first there's the US election.

US Election.

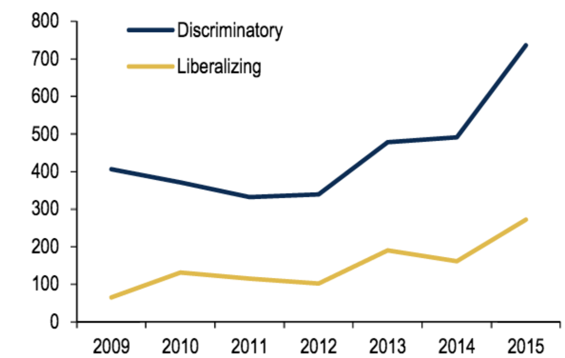
We've said on a number of occasions that Donald Trump is a veritable black swan walking. No one (including Trump himself) has a good idea about what his policies would ultimately entail for the domestic and global economies. What we do know is that he has a penchant for protectionism at a time when i) global trade is grinding to a halt, and ii) protectionist policies are already proliferating:

Chart 1: Global trade hits the brakes (index: 2005=100)



Source: BofA Merrill Lynch Global Research, CPB Netherlands Bureau for Economic Policy Analysis

Chart 2: Protectionism on the rise (number of measures)



Source: Global Trade Alert

Exhibit 2: Stagnating Global Trade Could Prevent Trade Growth From Converging Back to Global GDP Growth

Source: CPB, OEF, National Data, Morgan Stanley Research

(Charts: BofAML, Morgan Stanley)

Similarly, Hillary Clinton has been forced by the populism of Bernie Sanders to adopt a policy line that seems to favor a less liberal trade agenda.

On the fiscal front, there's scope for fiscal stimulus with either candidate it seems - more so from Trump. But that comes with a price and the price is more debt. Here's some color from Citi:

"Expect larger US Federal budget deficits and more public debt issuance regardless of which candidate wins. Both candidates' stated policies are unlikely to arrest the current baseline of expanding Federal debt and deficits under current legislation, according to the CBO and leading partisan and assorted non-partisan think tanks (see US Economics Weekly: Clinton and Trump Chose Winners & Losers in Trade and Debt Debates – Growth and Fiscal Policy Implications.). Neither Trump nor Clinton has articulated at this stage a clear roadmap that would simultaneously reduce the unbridled rise in expenditures on health and retirement entitlement programs or repair the broken tax code. Indeed, such sweeping promises and limited policy detail is part and parcel of the campaign process. Clinton and Trump's plans are still evolving, but so far elicit little confidence from economic observers, and likely also from investors. Congressional opposition likely will moderate candidates' plans for more spending and tax cuts."

"Economic outcomes vary by scenario, but expect heightened economic and policy uncertainty to persist. Uncertainty is likely to continue to rise regardless of who wins the election. Moreover, the movement towards global dis-integration, de-globalization and reduced trade may persist under either new US president. The candidates' views are evolving, but their stated policies, if implemented upon taking office, would suggest economic outcomes ranging from a modest increase in US economic activity (under Clinton or Trump) to recession (under Trump), in our view. We estimate that lingering uncertainty inherent in a regime change, exacerbated by an extremely divided electorate, would engender significant additional drag on GDP growth through the rest of this year and beyond."

Here's a summary of tail risks:

Figure 8. US Election Tail Risks: Political and Economic

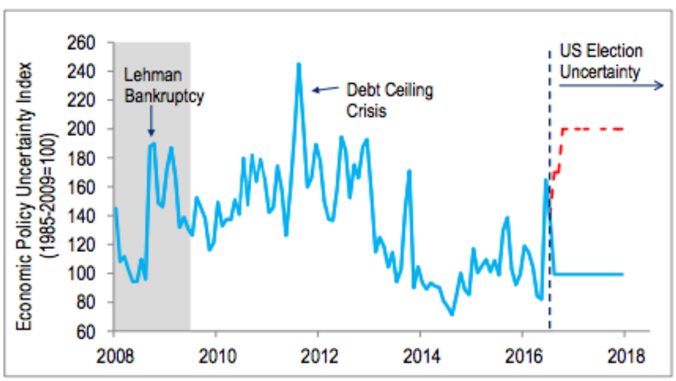
Political/Security Tail Risks	Economic Tail Risks	
Scenarios	Trump	Clinton
• Trump loses confidence of Republican party: drops out or is replaced	• Business investment collapses in wake of his election to presidency	• Steep tax hikes that crimp consumer spending and business investment
• Green or Libertarian party candidates gain significant mind share, threatening either Clinton's or Trump's prospects at the polls	• Consumers retrench	• Massive increase in public entitlement spending
• Very close election requiring recounts, and/or judicial intervention	• Layoffs, if his policies result in recession	• Policies that expand worker rights but hinder jobs creation
• Significant change in the composition of Congress (e.g. Democrats retake control of the Senate)	• Mass deportations of undocumented persons	• Immigration policies that erode US competitiveness (more difficult H1B visas)
• Significant change in the leadership of Congress (e.g. Paul Ryan loses his seat (and Speakership) in the House)	• International trade wars (more likely) reduce both exports and imports	• International trade wars (less likely)
• Post election: material economic and social policy changes; a constitutional crisis over the division of Federal Governmental powers	• Reduced central bank (Fed) independence and less onerous Dodd-Frank amendments	• Increased agency regulations, with Intensified anti-Wall Street Sentiment
• The next president remains subject to record-high negative ratings and low trust ratings among voters	• Runaway Federal budget deficits and unmanageable debt. Results: crowding out of investment, more frequent debt ceiling debacles (e.g. Federal government shutdowns, debt default)	• Runaway Federal budget deficits and unmanageable debt. Results: crowding out of investment, more frequent debt ceiling debacles (e.g. Federal government shutdowns, debt default)
• Increased domestic polarization, and less support for the merits of free trade, globalization, and international engagement, more generally		
• Terrorist attack on US oil or against US interests, widespread civil unrest		
• Major scandal erupts with game-changing implications		

Source: Citi Research.

(Chart: Citi)

And here's the outlook for uncertainty:

Figure 7. A Spike in Uncertainty Around Election Time Is a Significant Risk

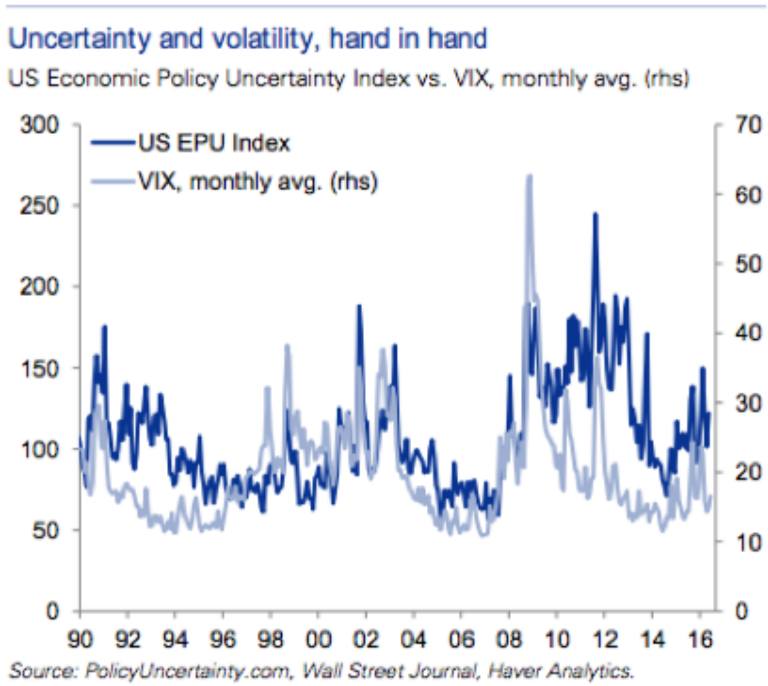


Note: Red dotted line denotes "high uncertainty" scenario.

Source: Political Uncertainty.com and Citi Research.

(Chart: Citi)

And do you know what comes with uncertainty? That's right, volatility:



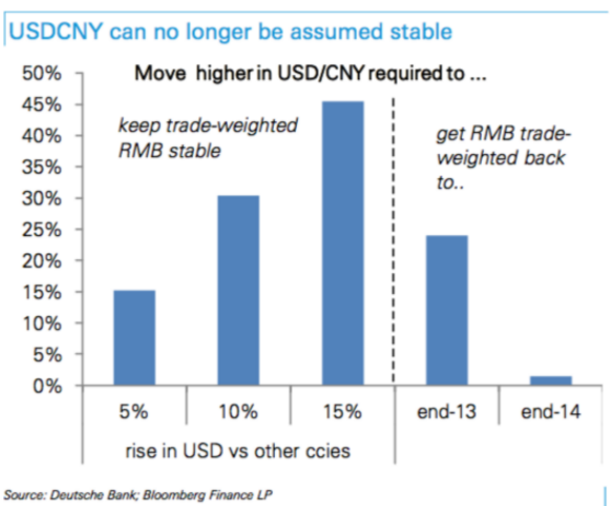
(Chart: Goldman)

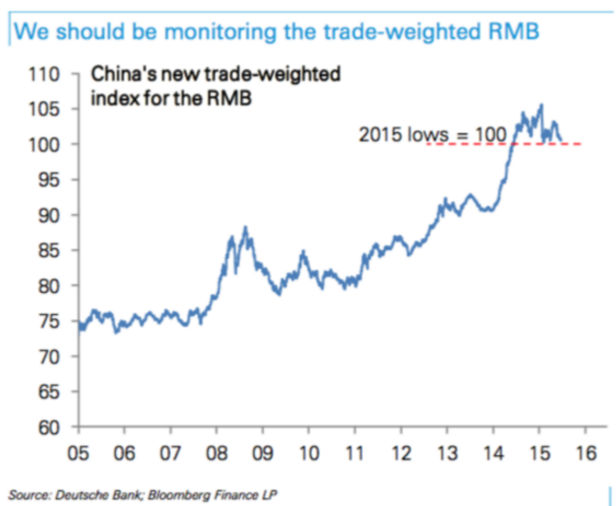
Fed Flight Path.

Moving on, you also have to be cognizant of the Fed's so-called "flight path." We've discussed this at length along with every other commentator and pundit in the financial universe, but it's worth noting (again) that the risk lies in increased policy divergence and the implications for the Chinese yuan devaluation.

The ECB and the BoJ have shown no signs that there is an end in sight for expansionary monetary policy. This means that even if the Fed stands pat, the FOMC is effectively tightening. If they hike, then so much the tighter. Some of this is offset by foreign demand for US debt, but the more policy divergence you get, the more you run the risk of sparking a dollar rally and that could be very painful for an already battered commodities complex and especially for emerging markets (think taper tantrum).

There's also the PBoC to worry about. Remember, the yuan's quasi-dollar peg means that as USD appreciates broadly, so too does the yuan. China doesn't need that. The calculus is complicated. The PBoC essentially wants to keep China's currency stable against the dollar but guide it lower against a trade-weighted basket. If the dollar appreciates against the other currencies in the basket, China has to ensure it appreciates against the yuan by even more if the PBoC wants to keep the currency stable. Here's the dynamic:





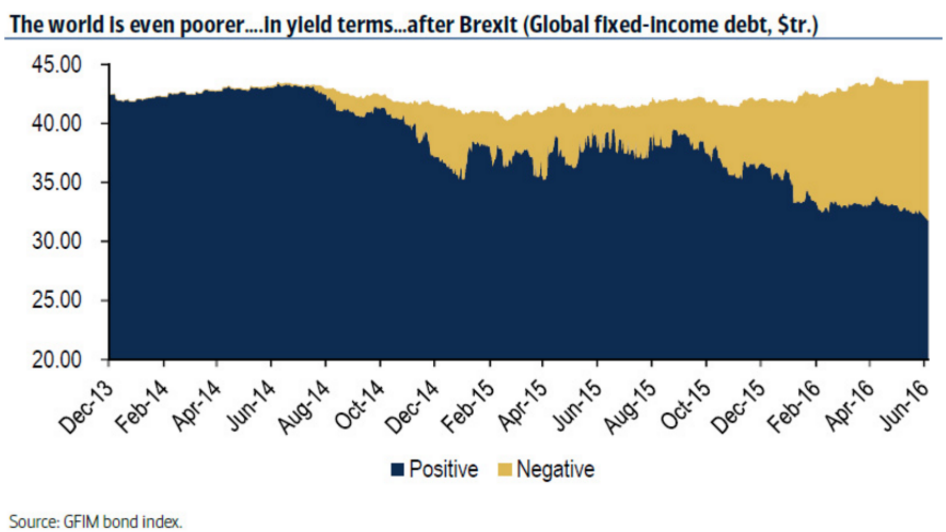
(Charts: Deutsche Bank)

The steady dollar has allowed China to execute on this precarious balancing act for most of this year, but a sharply stronger USD would upset the balance. And that, as we've seen, can be quite dramatic when it comes to how the market prices risk. Of course China also doesn't want to devaluation to spiral out of control, which means that when the balance is upset, they end up lower the fixings and then intervening in the spot market (i.e. burning FX reserves) just as they did on Wednesday.

Finally there is of course the argument that a stronger dollar could hurt the nascent US economic recovery by denting the profits of US multinationals.

Nefarious NIRP.

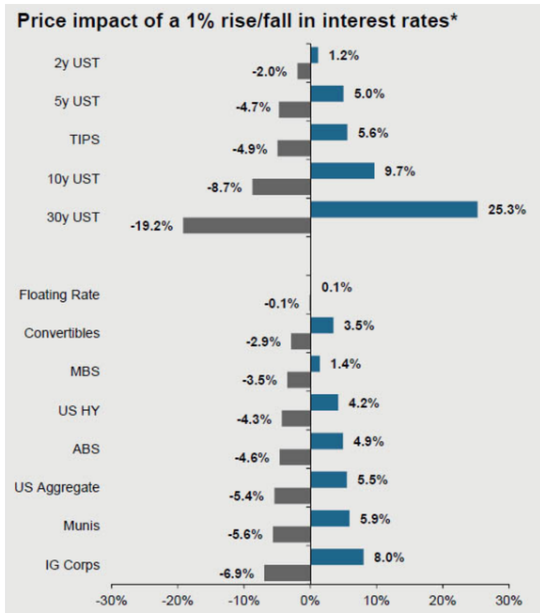
"$11 trillion of negative yielding bonds are not assets – they are liabilities. Factor that, Ms. Yellen into your asset price objective. You and your contemporaries have flipped $11 trillion from the left side to the right side of the global balance sheet."



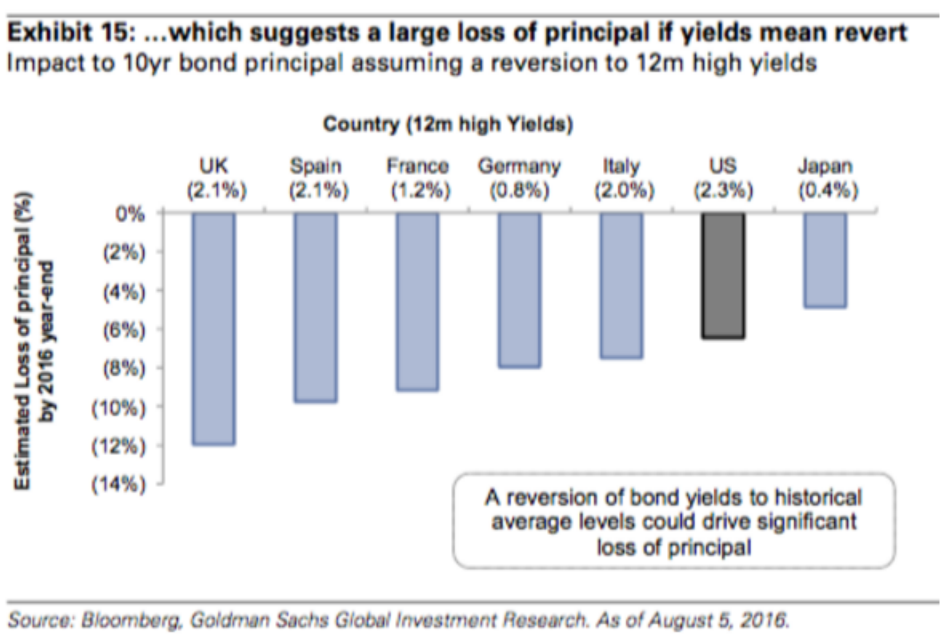
(Chart: BofAML)

That was the message Bill Gross sent to Janet Yellen on Wednesday and it underscores the extent to which global capitalism has been perverted by going on nine years of unconventional (by the way, at what point does it cease to be "un"conventional?) monetary policy.

The thing about trillions in negative yielding bonds is that if and when yields do rise, the impact is substantial. Have a look:



We've been over this before (see here). Here's another look at the issue via Goldman:



(Chart: Goldman)

Of course the whole thing is self-fulfilling. That is, once one class of fixed income goes negative yield-wise, investors will do two things, i) move out the curve, ii) move down the quality ladder. This flattens the curve, increases duration risk, and pushes yields on riskier debt to levels that don't even begin to approximate the risk investors are taking on by owning it.

China.

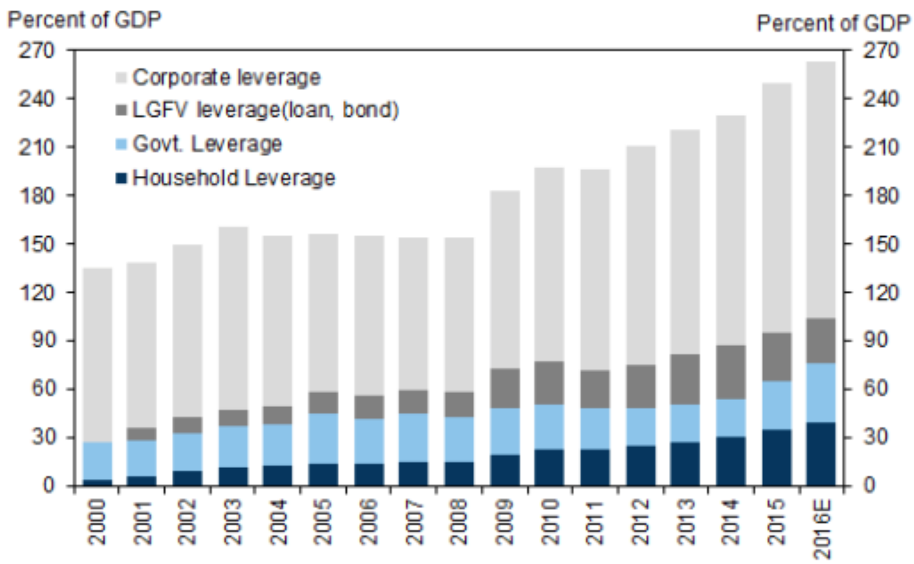
In case you haven't noticed, the engine of global growth and trade has hit stall speed. The Chinese economy, from which the world became conditioned to expect a perpetual bid for raw materials along with double-digit GDP prints, is decelerating as Beijing looks to mark a decisively difficult transition from a smokestack economy to a goods and services-driven model.

The country's GDP prints are a figment of President Xi's imagination. That is, they are whatever the Politburo says they are. Virtually no one believes the headline numbers but if you're a sellside strategist you have to pretend like you do, otherwise you'll be off the mark by a huge margin each quarter. And it's not even clear that China could report accurate figures if they wanted to. The difficulties of measuring growth across such a vast developing economy are myriad. Take the GDP deflator for instance. Generally speaking, China doesn't net out import prices when calculating the deflator, which means it approximates PPI more closely than it should. The read through is that in times of falling commodities prices, GDP is exaggerated. Effectively, they're understating inflation which in turn means real GDP is reported as being higher than it actually is.

But drilling down a bit, China has an overcapacity problem and it's particularly acute within the state owned enterprise (SOE) space. Overcapacity industrial companies are the most at risk. This year, we've seen a spike in defaults and it now appears the country has indeed entered a default cycle. That in turn, is expected to weigh on the banking sector which the likes of Kyle Bass believe will ultimately need a yuan-crushing recapitalization.

Here's a look at the overall debt picture:

Exhibit 2: Boom in debt since the global financial crisis

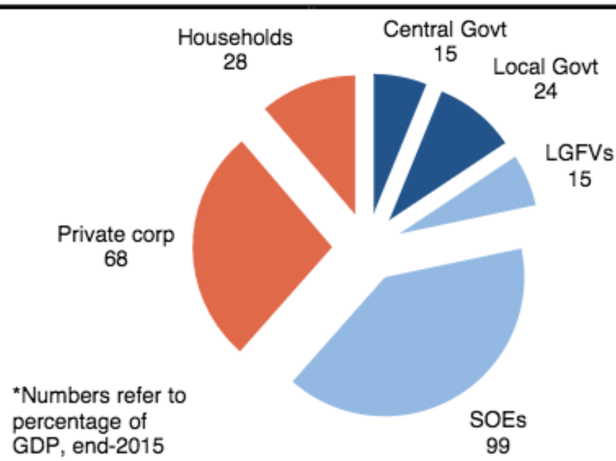


Source: CEIC, PBOC, NBS, FactSet, Goldman Sachs Global Investment Research

(Chart: Goldman)

And here's the breakdown by borrower:

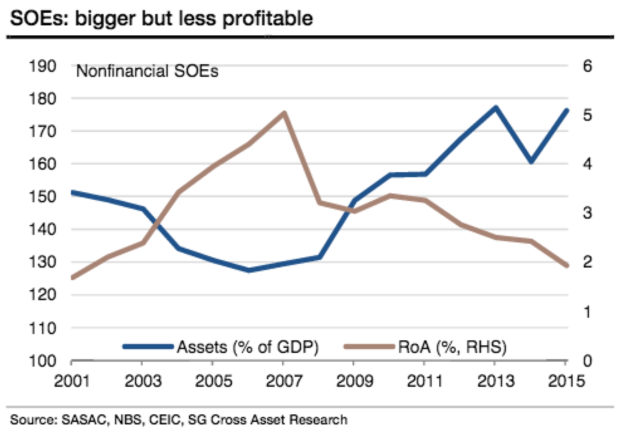
China's nonfinancial debt by borrower

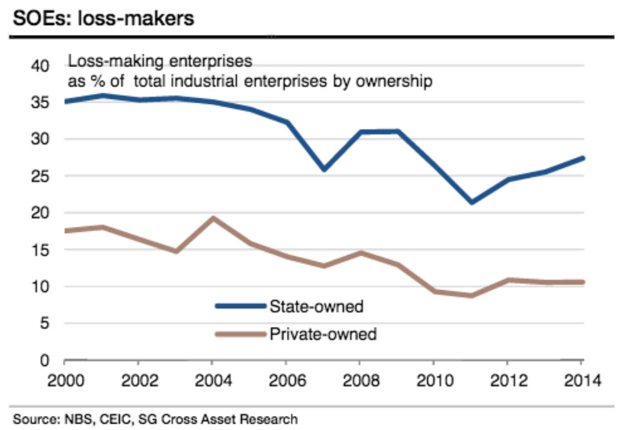


Notes: Total SOE liabilities are close to 120% of GDP and we assume 85% of those are financial debt. Source: NBS, PBoC, MoF, CEIC, SG Cross Asset Research/Economics.

(Chart: SocGen)

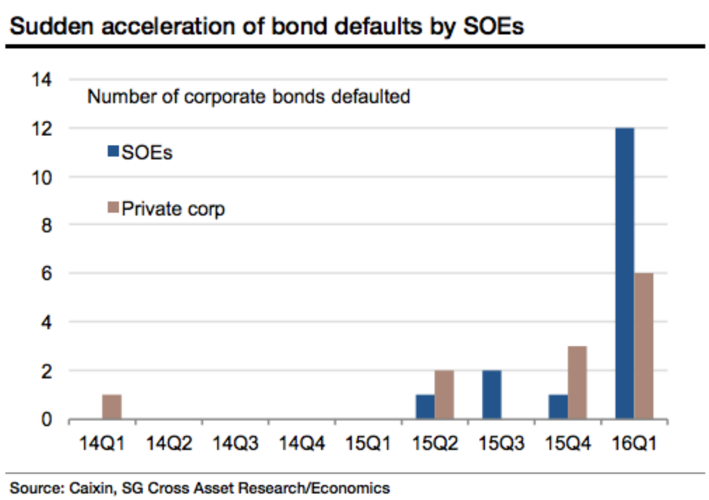
Now have a look at the economics of the SOE space:





(Chart: SocGen)

The SOEs are basically elephantine, government-sponsored loss-making machines. They desperately need to be restructured, but the problem is figuring out how to do that without causing massive job losses and thereby stoking a backlash from the country's downtrodden masses. Defaults by these enterprises have skyrocketed as have defaults in general:



(Chart: SocGen)

Now bear in mind, the country's banks still maintain that their non-performing loan (NPL) ratio is something like 1.75%. Frankly, that's absurd. As a reminder, Chinese banks have all kinds of ways of concealing credit risk. The shadow complex is a key conduit for what amounts to off-balance sheet lending to borrowers that have lost access to traditional loans. Despite these efforts, official NPLs are still rising although at a slower pace.


China's 'Big 4' banks
For Q2 or at end-June (vs Q1), %

	Net income growth	Non-performing loan ratio	Net interest margin
Industrial and Commercial Bank of China	1.0 (0.6)	1.55 (1.66)	2.21 (2.47)*
China Construction Bank	0.9 (1.4)	1.63 (1.63)	2.32 (2.40)
Agricultural Bank of China	0.5 (1.1)	2.40 (2.39)	2.31 (2.66)*
Bank of China	3.4 (1.7)	1.47 (1.43)	1.90 (1.97)
All commercial banks	-0.1 (6.3)	1.75 (1.75)	2.27 (2.35)

*Comparison figure is for Q4 2015
Sources; Bank statements, China Banking Regulatory Commission, CEIC

FT

(Chart: FT)

Here's a bit of color from FT:

"After years of fast profit rises driven by aggressive lending in support of China's manufacturing and construction booms, the big four lenders are pulling in their horns as they brace for fallout from government efforts to rein in debt and cut rampant overcapacity in basic material sectors."

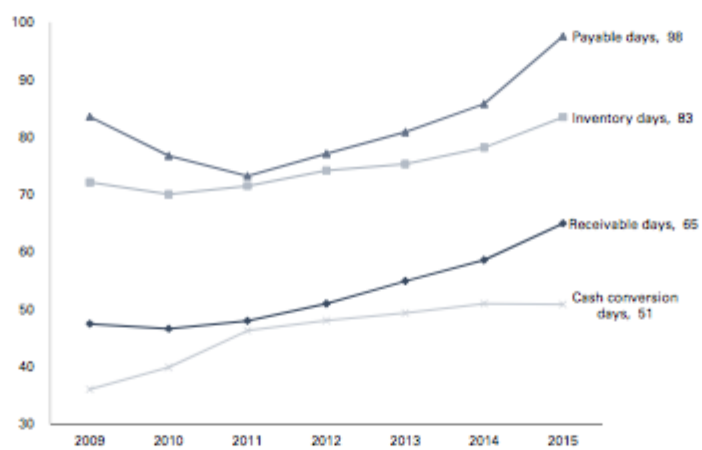
"Analysts warn that NPLs will probably resume rising in the coming quarters, with north-east China's coal and steel industries a major source of delinquencies. That will show up not only in rising NPLs, but also in loan restructurings and debt-for-equity swaps that will help troubled companies but impair bank balance sheets."

Right. And guess what happens when those balance sheets become too "impaired"? That's right, they'll have to be recapitalized. Here's an excerpt from a piece we posted earlier this year:

The math here is actually pretty simple. As [Bass told CNBC in February](), "they've let their banking system grow 1,000% in 10 years. It's now $34.5 trillion." Special mention loans sit at about, let's call it 3% to be conservative. That would be a trillion dollar hit to the banking system. If the PBoC only has $3 trillion in reserves and it takes, by the IMF's estimates, $2.7 trillion to manage the economy, they simply won't have any money left to recapitalize the banks - especially considering the capital flight that's been bleeding reserves for most of the last eight months. "They'll have to expand the PBoC balance sheet by trillions and trillions of dollars," Bass contends. When they do, look out below. Bass sees a 30-40% deval in the cards.

So clearly that's bad for risk. Finally, have a look at the rapid deterioration in fundamentals at Chinese corporates:

Exhibit 14: Cash conversion days stable...
Working capital conditions (excl. real estate)



Source: Capital IQ, Goldman Sachs Global Investment Research

(Chart: Goldman)

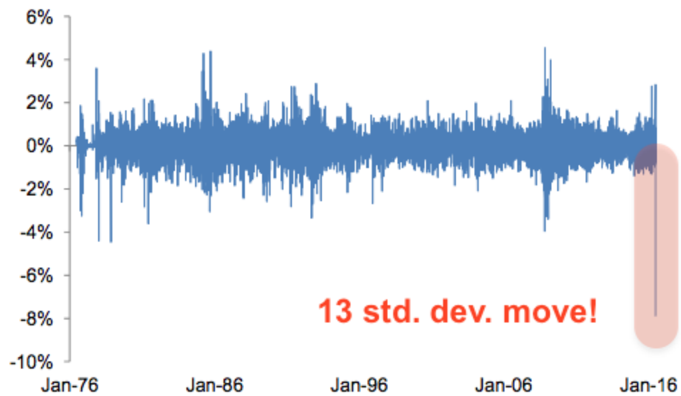
So what's the bottom line, you ask? Well, this from Citi:

"Both domestic and external conditions are looking more challenging for China's growth and financial stability in the second half of the year. Short of effective policy intervention, we expect China's growth will continue to slow, risking missing the growth target for a third consecutive year. Domestically, investment growth runs the risk of a freefall, weighed by sharp slowdowns in private and manufacturing sector investment. Structural reforms focusing on deleveraging and de-overcapacity will likely enlarge the output gap, increase unemployment, and dampen consumer sentiment. Externally, Brexit and renewed Euro area banking- sector stress will likely increase RMB exchange rate volatility, reduce Chinese export growth to the region further, and lead to weaker manufacturing activity."

Brexit.

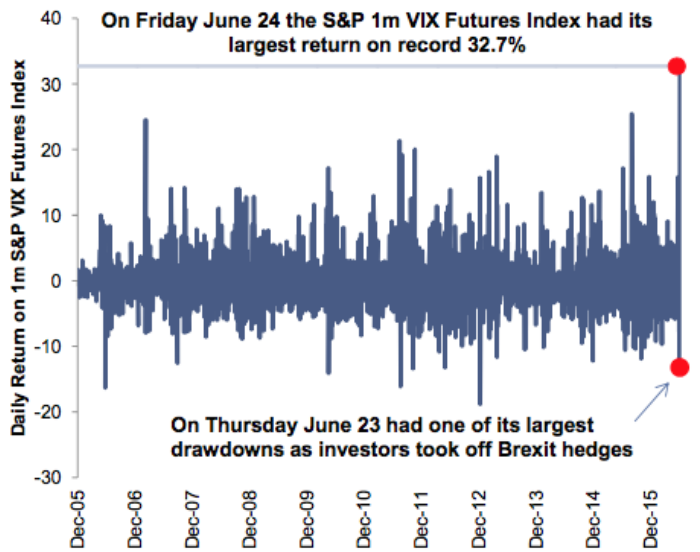
Some folks in the UK (who may or may not have known what the European Union actually was before they voted) decided they wanted to exit the EU. The knee-jerk reaction (charts Goldman):

Exhibit 1: GBP declined around 8% against USD, the largest move on record
Previous largest move lower was on 4.5% on November 1, 1978. As of 6/24/2016.



Source: Goldman Sachs Group Inc.

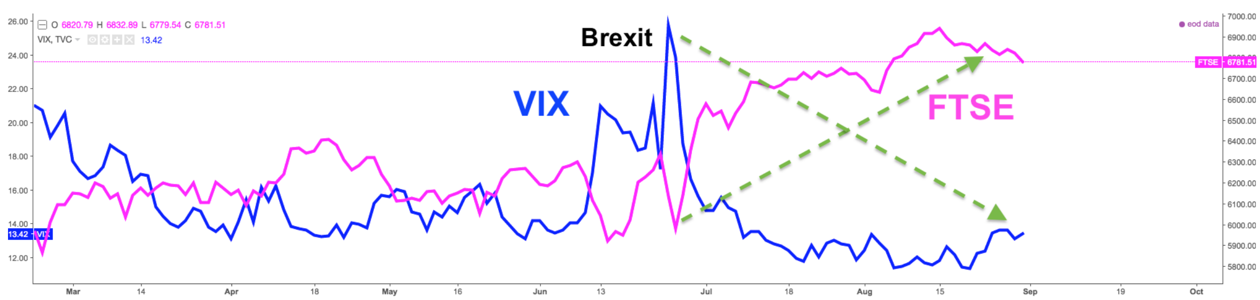
Exhibit 11: On Friday June 24 the S&P 1m VIX Futures Index had its largest return on record (32.7%).
Daily returns on the S&P Short-Term VIX Futures Index the benchmark for VIX ETPs like the VXX and VIXY.



Source: S&P Dow Jones Indices. Goldman Sachs Global Investment Research.

Right. So that's a 13-sigma move in sterling and the largest one-day move in the VIX ever.

Then do you know what happened next? This:



The market simply forgot it ever happened. Of course the Bank of England didn't. And neither did UK property funds which were [forced to throw up the gates]() as redemptions came rolling in. The BoE cut rates this month, restarted its gilt purchase program, and followed the ECB into corporate bond buying as well. The risks to the UK economy are well documented. Here's what BofAML said in the immediate aftermath of the vote:

"Once the dust of the knee-jerk market reaction settles, we think that the UK's economy will clearly be the main victim, but also that the shock for the Euro area and the global economy is likely to be significant. Policy responses will be needed beyond the 'first-aid' remedy market disruption normally requires."

"Uncertainty on the UK's future relationship with the EU will remain high within UK and European institutions for a long time, possibly for the entirety of the two year transition period provisioned by the European Treaty in case of exit. This will come from a combination of (i) a desire by the EU not to offer too much to the UK to avoid fuelling temptations to exit elsewhere, (ii) a difficulty for the EU member states to agree on a common approach to the UK (emigration countries such as Poland will likely focus on free circulation of labour, Ireland on practical considerations on border controls, France and Germany on financial services etc...) and (iii) the political turmoil a Brexit creates in the UK itself."

Some of the domestic political uncertainty has subsided with the new Prime Minister but as the following from the NY Times makes clear, there's a lot of ground to cover ahead:

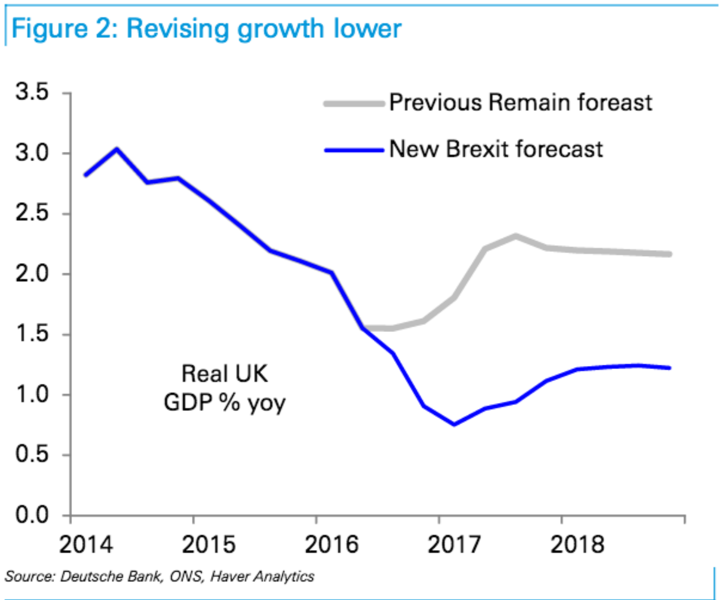
"Since Britain's vote in June to quit the European Union, its government has promised repeatedly to make a success of withdrawal, known as Brexit."

"More than two months later, however, it still cannot say how."

"On Wednesday, Prime Minister Theresa May called cabinet ministers to a brainstorming session about the withdrawal, pledging to examine 'the next steps' for Britain and to identify 'opportunities that are now open to us as we forge a new role' in the world."

"However, in ministerial offices, where turf wars have rapidly broken out, advocates of the withdrawal have discovered that four decades of European integration have left Britain so deeply embedded in the 28-nation bloc that there is no easy escape route."

Here's a simple graph from Deutsche which shows how the bank's expectations for UK growth changed after the referendum:



(Chart: Deutsche Bank)

And here's the bank's outlook for EU growth in the "Leave" versus "Stay" scenarios:

Figure 2: Euro area & member state real GDP forecasts assuming the UK *leaves* the EU

Euro Area real GDP forecasts assuming UK leaves the EU (Leave)

% yoy	GDP	Private consumption	Government	Investment	Exports	Imports	*Domestic demand (DFS)*	*Inventories*	*Net trade*	MEMO: EU GDP
							Contributions to GDP growth, pp:			
2016	1.6	1.8	1.5	2.7	3.1	4.1	*1.8*	*0.1*	*-0.3*	1.7
2017	1.1	1.3	1.0	1.9	3.5	4.1	*1.3*	*-0.1*	*-0.1*	1.2

Euro Area Member State real GDP forecasts assuming UK leaves the EU (Leave)

% yoy	Germany	France	Italy	Spain	Netherlands	Belgium	Austria	Finland	Greece	Portugal	Ireland
2016	1.7	1.5	0.9	2.8	1.3	1.2	1.1	1.1	-0.7	1.0	5.0
2017	1.3	1.3	0.4	1.7	0.9	0.9	1.1	0.7	1.2	1.1	2.9

Euro Area, difference -- Leave scenario relative to Remain scenario

% yoy	GDP	Private consumption	Government	Investment	Exports	Imports	*Domestic demand (DFS)*	*Inventories*	*Net trade*	MEMO: EU GDP
							Contributions to GDP growth, pp:			
2016	-0.1	0.0	0.0	-0.1	-0.1	-0.1	*0.0*	*0.0*	*0.0*	0.0
2017	-0.4	-0.2	0.1	-0.7	-0.9	-0.6	*-0.2*	*0.0*	*-0.1*	-0.5

Euro Area Member State, difference -- Leave scenario relative to Remain scenario

% yoy	Germany	France	Italy	Spain	Netherlands	Belgium	Austria	Finland	Greece	Portugal	Ireland
2016	0.0	0.0	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
2017	-0.3	-0.3	-0.6	-0.5	-0.6	-0.3	-0.3	-0.2	-0.4	-0.4	-1.1

Source: Deutsche Bank, Eurostat

(Table: Deutsche Bank)

For their part, the bank had the following to say about the prospects for the EU's future:

"It is impossible to talk about what the UK decision to leave the EU means for the euro area economy without knowing the political scenario that will prevail. A leap towards a more integrated Europe is highly unlikely, in our view. At the same time, a general unraveling of the EU is unlikely too. This points to a classic European 'muddle through'. That said, it is not a riskless situation. Europe has a packed political calendar over the next year. For example, Italy's Senate referendum in October bears careful watching."

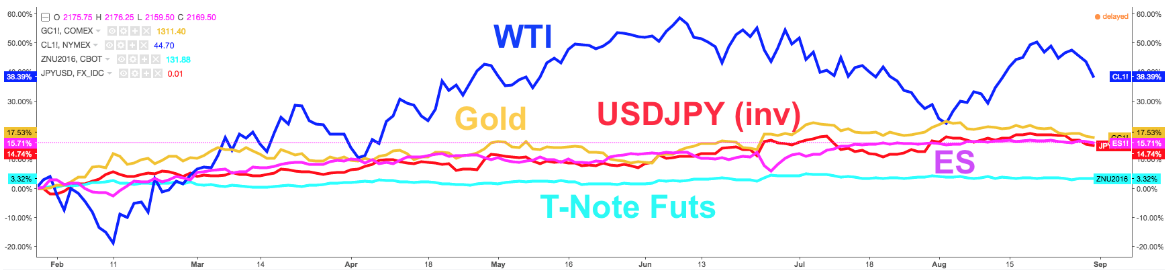
That strikes at the heart of the issue. The political ramifications here are probably more important than the economic consequences. What Brexit represented was a resounding victory for the same populist wave that's propelled Donald Trump in the US, Frauke Petry in Germany, and other nationalist politicians across Europe. It represents a shift in sentiment towards an anti-integration and anti-globalization view of the world.

The economic fallout from that worldview (should it prevail in other countries) will be far more profound than the economic fallout from Brexit itself.

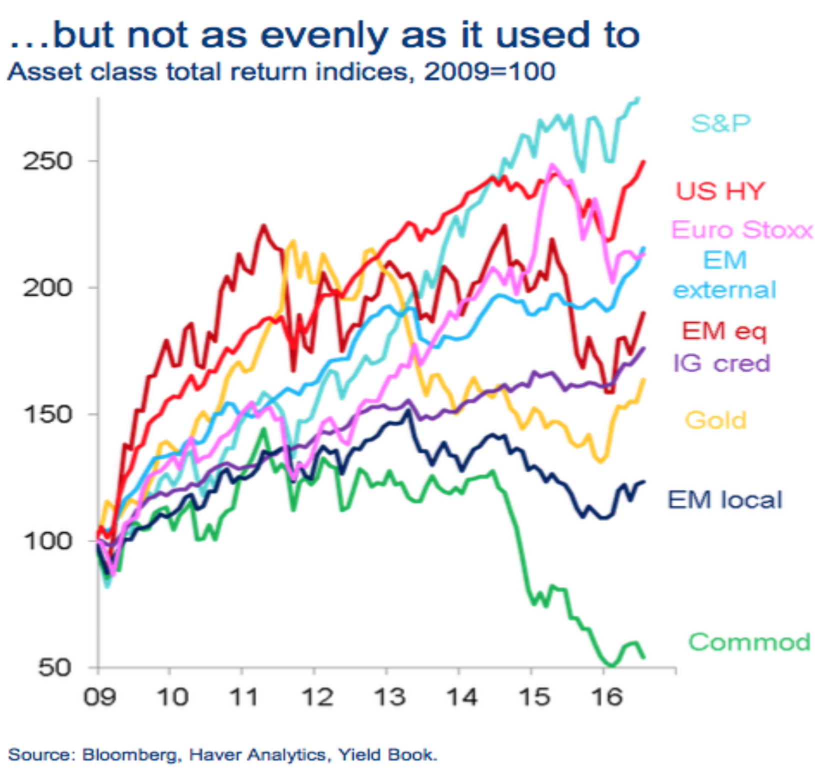
The point: this was more a political black swan than an economic tail event, but the political fallout could well mushroom into an economic tailspin as a world already struggling with lackluster trade growth (see above) is forced to grapple with a protectionist backlash. That's the risk. Trade accordingly.

Gold & Oil.

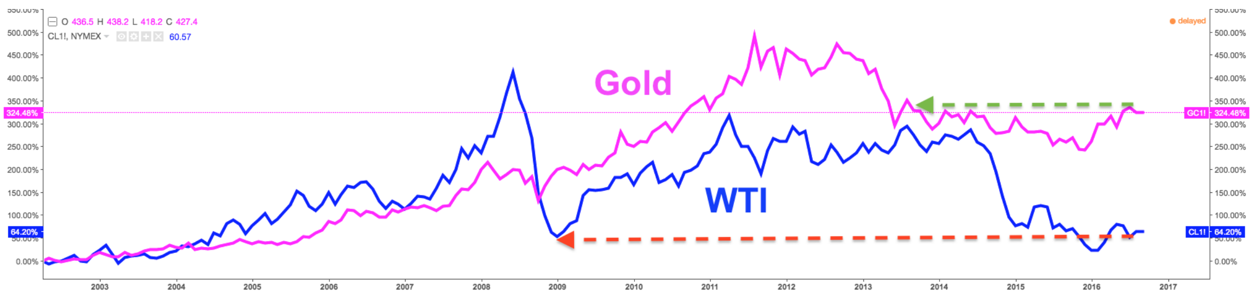
Have you noticed something strange about asset prices coming off the February lows? Yeah? We have too. Have a look:



Basically, it's all up; risk-on and risk-off at the same time. That speaks a bit to the following chart from Citi's Matt King about post-crisis cross-asset correlation:



But the bigger picture when it comes to oil and gold looks like this:



Essentially you've got gold sitting near multi-year highs while crude is of course still near multi-year lows thanks to the global deflationary supply glut and geopolitical concerns that have seen the Sunni-Shiite sectarian war spill over into the oil market.

When it comes to crude, the downside (and thus deflationary, risk-off) risks are clear. The Saudis, Russians, Iranians, Iraqis, Kuwaitis, and the UAE are all pumping near record levels. Thus a production "freeze" really means nothing. As we've discussed at length, if you're pumping at capacity, you didn't "freeze" output, output "froze" itself. Besides, heightened tensions between Riyadh and Tehran mean the prospects for any kind of agreement to support prices are grim.

On top of that, US production stubbornly refuses to die, thanks in no small part to wide open capital markets that allow cash flow negative producers to plug funding gaps. The problem is that US production generally is expected to come back online at ~$50-$55/bbl and that additional supply effectively serves as a self-defeating cap on prices. The prospects for a stronger dollar (outlined above) only darken the outlook further. Prices fell 3% on Wednesday after the EIA reported a larger than expected build. Oil has still had a good month but it's truly difficult to see how any bounce above $50 (give or take) can be sustained given the dynamics at play.

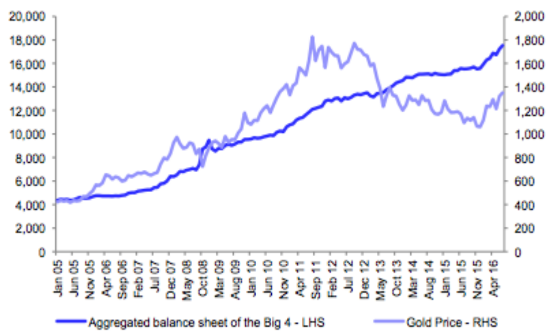
Meanwhile, gold is up some 24% YTD. The argument for the yellow metal is pretty simple. The more central banks expand their balance sheets the more valuable will be the world's inflation hedge par excellence. Here's Deutsche Bank:

"The balance sheets of the main four central banks have expanded by 300% since the beginning of 2005. The PBoC balance sheet has been steadily increasing over the period, with a leveling off in 2015; the Fed kicked off its expansion during the global financial crisis, and has expanded its balance sheet through a series of QE programmes, but has recently leveled off since mid

2014; the BoJ has picked up the expansionary mantel since 2013, and more recently the ECB has resumed an expansionary policy since the beginning of 2015. The net result is however a consistent and steady expansion, which accelerated through the global financial crisis (Chart 9).”

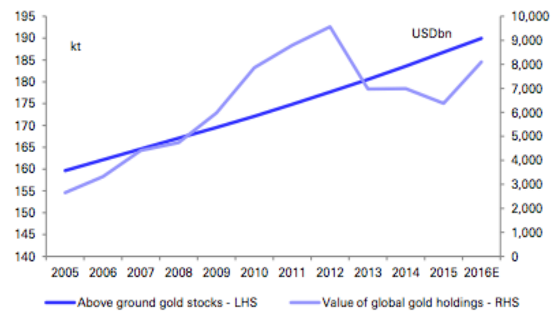
“Over the same period as the aggregate central bank balance sheet expanded by 300%, global above ground stocks grew by 19% in tonnage terms or c.200% in value terms (Chart 10). If we were to assume that the value of gold should appreciate to keep the overall value of the big four aggregate balance sheet equivalent to that of the value of the above ground gold stocks, then gold should be trading closer to USD1,700/oz.”

Figure 9: The gold price has lagged the central bank balance sheet growth since the sharp correction in 2013



Source: Deutsche Bank, Bloomberg Finance LP

Figure 10: The gold miners add 2,500 – 3,000 tonnes of gold per annum



Source: Deutsche Bank, Bloomberg Finance LP

(Charts: Deutsche Bank)

Just watch out for a Fed hike. Wednesday’s ADP data sent gold to a two-month low.

Geopolitics.

While there are always geopolitical landmines out there, it's fairly easy to make the argument that the current geopolitical landscape is as precarious as it's been in decades.

The most obvious problem is Syria. Few understand just how dangerous the country's five-year civil war has become. For one thing, some 300,000 people are dead. But it's important to understand the strategic alliances at play and what they mean for power politics.

There's an argument to be made for the supposed "conspiracy theory" that the US allowed ISIS to destabilize Syria in the interest of assisting Washington's regional Sunni allies (which include Turkey and Saudi Arabia) in ousting the Alawite government in Damascus and thus cutting a key supply line between Iran and Hezbollah in Lebanon. This became even more urgent from the perspective of the Gulf monarchies once Iran came off sanctions. When Russia officially entered the fray and began flying combat missions from Latakia last September, they were by definition bombing Sunnis (the insurgency, terrorist or otherwise, is largely Sunni). That obviously raised the stakes as did the comparative success of Moscow's scorched earth strategy versus Washington's "targeted strikes" when it came to rolling back ISIS.

Similar sectarian fights are ongoing in Yemen and Iraq. In Yemen, the Houthis are backed by Iran and are battling for control of the country against a Saudi-led coalition. In Iraq, Iran's Shiite militias are assisting the Iraqi regulars in ousting Sunni ISIS.

In essence, Iran and Saudi Arabia are behind it all and each has a superpower sponsor - the US for the Saudis and Russia for the Iranians. Turkey has served as an especially volatile wildcard. The Turkish government is effectively waging a civil war against the country's Kurdish population which creates problems for the US when it comes to actively arming Kurdish fighters directly across the border in Syria.

In short, the region is hosting what amounts to a mini-world war.

Meanwhile, in the South China Sea, Beijing is intent on projecting its maritime might by building islands atop reefs in the Spratlys. This is cause for grave concern among Washington's Asia-Pac allies and the entire watery theatre (through which $5 trillion in global trade passes each year) is now a powderkeg. Japan is of course along for the ride.

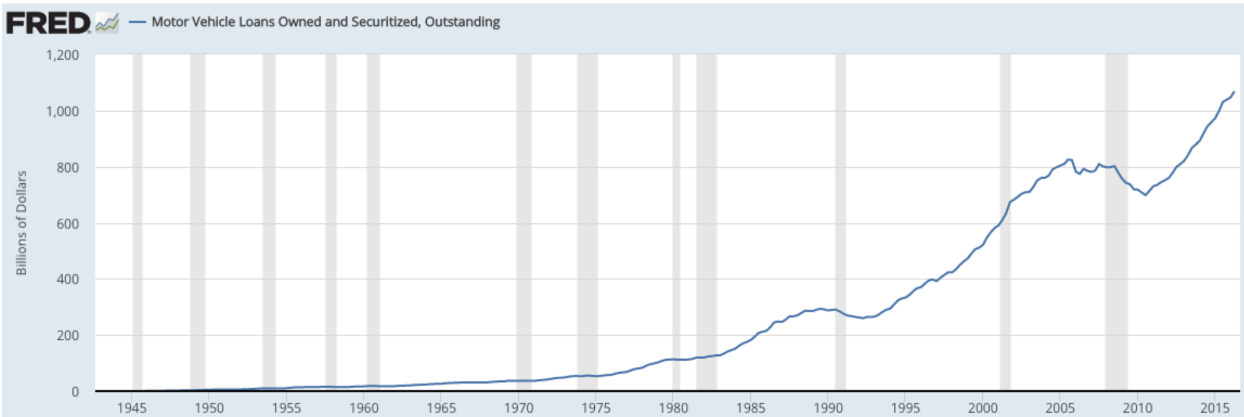
The wars in Syria, Iraq, Afghanistan, and Yemen have sent millions of refugees fleeing to Western Europe. The influx of migrants has effectively splintered the EU and brought an end to Schengen, the bloc's vision for a borderless utopia. News of assaults combined with major incidents of terrorism in Paris and Brussels and near daily reports of violence purportedly perpetrated by Muslims has fed into a kind of xenophobic nationalism that threatens to upend the political status quo in the name of defending Europe's "Christian heritage," to quote Hungarian Prime Minister Viktor Orban.

Finally, there's the simmering tension in Ukraine and Crimea, where Russia is keen on reestablishing dominance. That sets up a potential conflict with NATO, the ramifications of which one can only begin to fathom.

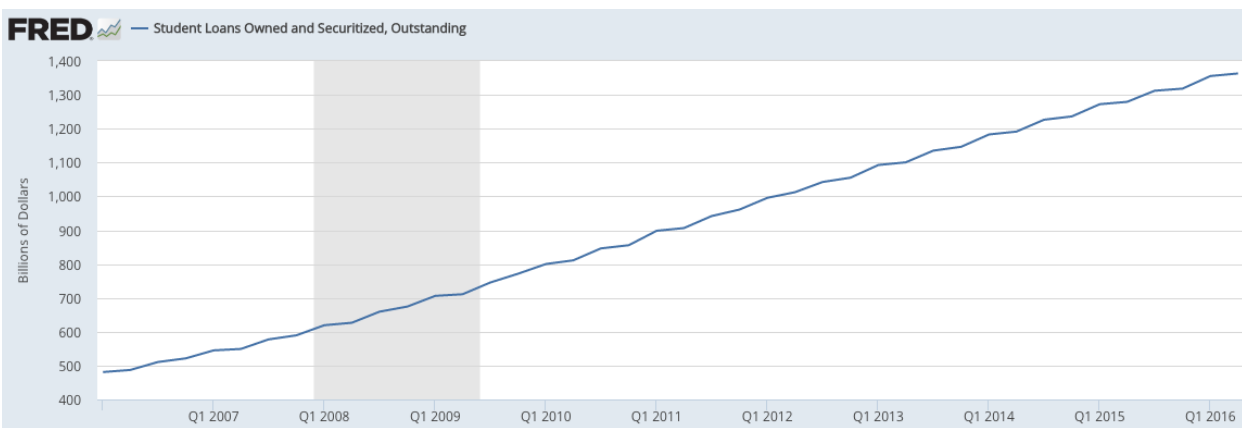
Throw in a possible Trump White House and you've got yourself a decisively unstable geopolitical order. And yet… VIX 14.

Student Debt.

America is sitting on two trillion dollar bubbles. One is auto loans:



The other is student debt:



It's no secret that the rising cost of a college education is crippling America's graduates. It's also exceedingly possible that the debt load students are saddled with upon graduation (which averages between $30,000 and $35,000) is inhibiting household formation. The cost of higher education was a cornerstone of Bernie Sanders' presidential bid and is also a focal point of the Clinton campaign.

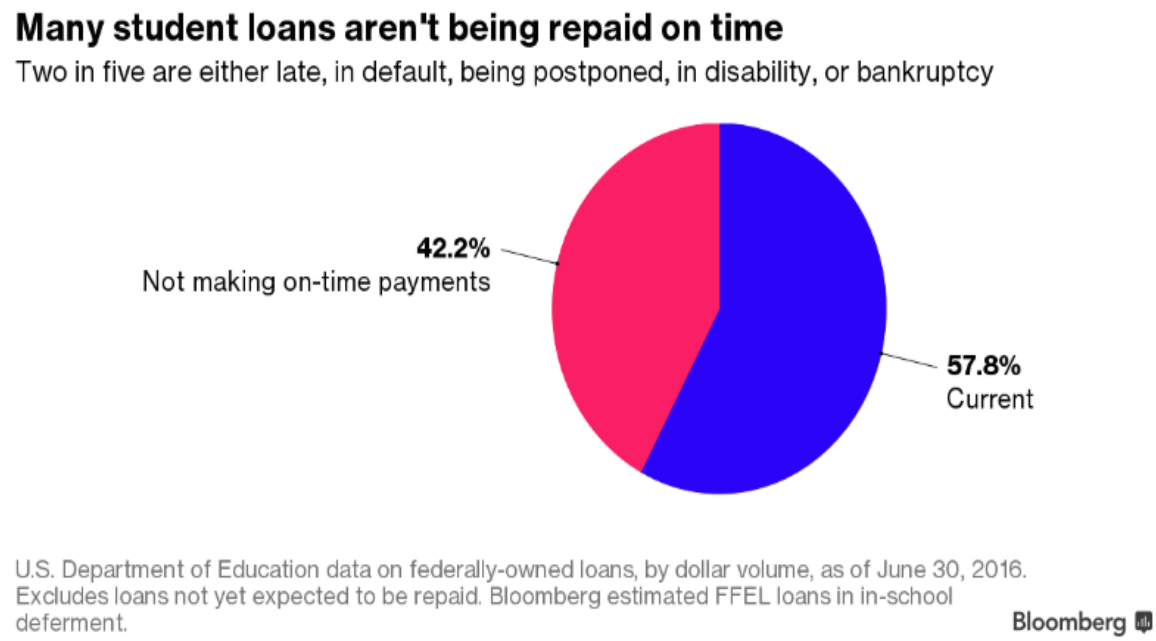
As [Bloomberg noted] recently:

"Government-backed student debt is big business: About one in six U.S. adults has a student loan owned or guaranteed by taxpayers, and the feds pay their contracted loan servicers and debt collectors close to $2 billion annually to counsel borrowers on their repayment options and collect monthly payments on nearly $1.3 trillion of federal student debt."

While headline delinquencies are falling…

(Chart: Bloomberg)

...a further breakdown of the numbers reveals a less sanguine picture. For instance, as Bloomberg goes on to point out, "Less than $3 of every $5 is being repaid on time. [and] more than 42 percent of loan balances are either delinquent, temporarily postponed, in default or in bankruptcy, or borrowers are seeking to shed the debt by convincing the feds that their disability prevents them from ever repaying what they owe."



(Chart: Bloomberg)

Breaking down delinquencies and defaults on student debt is a notoriously difficult and convoluted exercise - probably because it involves navigating programs set up by government bureaucracies. But we wanted to draw your attention to one particular relief plan called “income based repayment” or “IBR.” Here’s how one servicer describes the plan:

“Based on your adjusted gross income (individually or with your spouse, as applicable), your family size, and your state of residence. May be less than the interest that accrues each month. May be as low as $0.00. Are recalculated annually.”

Got that? Note the whole thing about monthly payments “may be as low as $0.” In other words, if you don’t make enough to meet a certain threshold, you don’t have to pay anything. But here’s where this gets interesting. Again from a government loan servicer:

“Offers loan forgiveness after 25 years if you make the equivalent of 300 qualifying monthly payments.”

Here's the problem (this is from IBR.org):

"What are qualifying payments? The Department of Education has indicated that the following types of payments will count towards IBR's 25-year forgiveness period, as long as you are in IBR at some point during those 25 years.

- Payments made in the Income Contingent Repayment plan (ICR) before July 1, 2009.
- All payments made on or after July 1, 2009 in the IBR, Income Contingent Repayment (ICR), and Standard (10-year) Repayment plans.
- Periods when the borrower has a calculated payment of zero in IBR or ICR (this occurs when your income is at or below 150% of the poverty level for your family size).
- Periods on or after July 1, 2009, when the borrower has been granted an economic hardship deferment."

So note that second to last bullet point. If your income is at or below 150% of the poverty level and your required payment under IBR is thus zero that zero "payment" counts as a "qualifying payment" towards the 300 you need to have your loan forgiven. Theoretically then, it's possible to never make a single payment and have your entire loan forgiven in 25 years.

Guess who foots the bill for that? That's right, taxpayers. Here's a Bloomberg estimate of how much this will ultimately cost:

"The Congressional Budget Office estimates that, for loans originated in 2015 or after, the programs will cost the government an additional $39 billion over the next decade. That's more than the agency spends each year on Pell grants, the public scholarship program for low-income students."

Here's something else to consider. How are these delinquency numbers really calculated? For instance, if you include in the denominator all of the students who are in deferment or forbearance (i.e. not making payments), well then the numbers will look better. But that makes no sense. You can't include people in deferment and forbearance in the denominator because they aren't yet required to make payments. Guess what happens when you strip those numbers out and include only those borrowers who are currently in repayment? The delinquency rate skyrockets to nearly 30%. Here's what the St. Louis Fed had to say last year:

"As a consequence, if we adjust the delinquency rate to consider that only a fraction of the borrowers have payments due, this level of delinquency is very concerning: A delinquency rate of 15 percent for all student loan borrowers implies a delinquency rate of 27.3 percent for borrowers with loans in repayment. This level of delinquency is much higher than for any other type of debt (credit cards, auto loans, mortgages, and so on)."

Now that is truly scary. What does this mean for the economy? Well, these students are effectively saddled with a debt burden that amounts to an entry level BMW. That's going to have a profound effect on their propensity to spend and save enough money to make down payments on homes. That in turn, leads to increased demand for rentals which or course drives up rents and before you know it, graduates are stuck between homes they can't make a down payment on and rentals they can't afford.

That, in a nutshell, is the student loan dilemma. Please mail all suggestions to the Department of Education.

Conclusion.

There's a palpable sense that central bankers will be able to keep all of this afloat with endless iterations of this or that asset monetization program, and ultra-cheap money.

But some of these factors are beyond central banker control. The FOMC cannot, for instance, keep one of the mishmash of state actors running around in Syria from "accidentally" coming into direct contact with each other. Central bankers also cannot control the rise of populism and nationalism in both the US and Europe. On Sunday for instance, Fruake Petry's AfD (the anti-immigration party that's been accused of being sympathetic to neo-Nazi groups) won 21% of the vote in regional elections dealing a crushing blow to Chancellor Angela Merkel in her home district of Mecklenburg-Vorpommern.

Central banks also cannot control the outcome of the US election - all they can do is forestall a rate hike until December. And make no mistake, Donald Trump is far from defeat despite criticism from all corners including the Republican National Committee.

As for the student loan "problem," perhaps Bill Ackman said it best last year: "If you think about the trillion dollars of student loans we have outstanding, there's no way students are going to pay it back." No. No, there's not.

And yet here we sit. Nearly 18X on the S&P, bonds surging ever higher as the central bank bid serves as a veritable put, and everyone's simply strolling around, zombie-like as if this can continue in perpetuity.

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