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First Quarter Letter
April 29, 2015

Dear Clients and Friends,

The first quarter of 2015 was not unique in that the period lasted exactly 90 days with certain asset classes experiencing more volatility than others, while plenty of drama between January 1st and March 31st kept CNBC very busy. New quarter - same as the old quarter. You don't need me to report on the mundane details because your diversified holdings show you the ins and outs of how equity and fixed income markets fared. No, this letter has reached you because you expect me to do more than read the teleprompter to report stock returns or meaningless economic forecasts. It's my job to use this medium to bring you value - or at least something of a look-in at my thinking. This time I have a doozy.

I detest sensationalism, economic prognosticators even more, so trust me when I say I don't play the "Danger!" card loosely. That said, *there's something happening out there*: **negative interest rates**. Negative rates don't compel the same sense of imminent danger as the threat of a nuclear holocaust, an economic depression or climate change, but in the financial world this is truly a strange phenomenon. Seriously: Truly. Strange. X-Files strange.

If you haven't heard of negative interest rates, here's my first example: you're in the market for a $500K mortgage to purchase a home and a bank has agreed to lend you the $500K. Except, instead of YOU paying the bank an agreed upon fixed rate of interest to compensate their risk, they loan you the $500K and agree to pay YOU a *dividend* every month to say thanks for the pleasure of lending you money. All you have to do is pay back the $500K by the end of the term. Sounds too good to be true for a borrower, right? If I borrowed a dollar from you today while promising to pay you back 90 cents tomorrow, you'd never take the deal without being promised, at the very least, you'd get your dollar back, right? Wacky stuff.

This is as close to financial insanity as it gets. Switzerland recently auctioned off brand new 10-year notes at a negative yield to investors and reports indicate over 25% of the world's government debt carries negative yields to owners. The fundamentals and assumptions of financial principles are being tested, stressed, and flipped upside down. Central bank easing, expected deflation and excessive fear are all possible culprits to explain the existence of negative yields. I could spend pages fully discussing the possible reasons for negative interest rates but the cause is not the interesting part - it's the desire to know how this all pans out years from now.

The bottom line in any market is that supply and demand set the price for everything. Right now, the demand for fixed income products is astronomical in a growing percentage of the world and the shadow being cast is becoming ominous. We have seen excessive demand for various products in the past: tulip bubbles in the 1600s, shares of the South Sea Company in the 1700s, to oil in the 1970s, tech stocks in the late

90s and housing before the 2008 financial crisis. It's never tasteful to throw the word "bubble" around but if the textbook definition of a bubble is when no reasonable return could ever be had going forward for a certain product, **then the presence of negative interest rates is quite literally the most perfect definition of a bubble I could ever imagine**. An investor now buys a bond, holds it, guarantees a negative return even before inflation. No chance of a positive return if she holds onto the bond. And if she's buying the bond in hopes of even lower interest rates? That's picking up nickels in front of a steamroller.

How wild is this? I'll try another example. You walk into a crowded party and begin to mingle, except you notice a very strange sight. There's a guy sleeping in the corner, but this is no ordinary guy. He's very obviously an escaped convict in a bright orange jumpsuit, with broken hand cuffs on his wrists, and leaned against the wall next to him is something you can't believe: a bazooka! Now, why, you ask yourself, would this room full of seemingly logical and rational group of party goers be allowing an escaped prisoner, someone clearly capable of committing a terrible crime, to remain asleep in their presence with a loaded weapon of mass destruction? Good question, they're obviously behaving in a strange manner. Maybe the DJ is really good?

The answer is that somehow this group has decided to accept the risk. Maybe they're scared of the alternative of waking him up - he can't hurt anyone sleeping, after all. Maybe each individual partygoer fears going against the group, not unlike those buying bonds at negative yields, because when has a large mass of people ever been wrong? Maybe they have an irrational fear that outside the party exists a whole bus load of dozens more fugitives with bazookas so they've accepted their lone fugitive in the corner. In truth, the fugitive remains in the corner because of psychological factors affecting the group as a whole, just as the nuances of fear and greed in markets continue to allow negative interests to persist. You wouldn't be alone in thinking that leaving the party pronto (like not buying negative yielding products) actually makes much more sense.

I'm not saying that the presence of negative interest rates will necessarily lead to an explosive ending (like a fugitive with a bazooka) but it's the fact that the traders and investors of the world - like the partygoers - continue to willingly allow an insanely dysfunctional situation to continue. By continuing to purchase bonds with negative yields, market participants are doing the equivalent of telling the cops, "nope, no fugitives here!" They have the chance at each auction to say "no thanks," causing the market rate of interest to rise, but they don't. They're hanging up on the 911 operator.

The saga of negative interest rates very well could slowly end without a fuss or without a major market dislocation, but that's not exactly my hunch, to be clear. I do simply want to point out we're clearly at a very notable time in history. If 2015 was a single page on a calendar of the 21st century then it's time to bend the corner of the page. When US treasury bonds yielded over 15% in the 1980s there was, in perfect hindsight, a major opportunity. Are we living in a similar situation some 30 years later but with opposite implications? I think we very well may be.

Whether there is collateral damage or unintended consequences remains to be seen but my skepticism of holding large exposure to interest rate risk remains. If you've ever struggled to build a fire, then you know where there's smoke there's not necessarily fire like the saying goes. The growing persistence of negative interest rates does not guarantee any viral result within markets nor does it foretell imminent chaos, but just know that it's smoky as hell out there right now.

Thank you for your continued trust - and an especially big kudos to you if you managed to make it through 1200 words about negative interest rates.

Sincerely,

Tyler Linsten