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HOW MUCH TIME DO YOU
HAVE FOR...

SHORT-SELLING?



Two
SECONDS

U.S. stock prices are at frothy all-time highs...
valuations have reached nosebleed levels...
and the Federal Reserve is tightening its
monetary policy.

It's time to talk about shorting the U.S.
stock market.

ONE MINUTE

When's the right time to short the stock market?

Get this question right, you'll set yourself up for large financial rewards.

But get the timing of a short wrong - even by a little bit - and you risk losing limitless amounts of money.

Short selling, as you probably know, is betting that a stock or market will decline. These days, with stocks at precarious heights, short-selling is an important tool to have in your investing toolbox.

In today's issue, we'll explain what you should know about short selling. We're pleased to say our analysis is informed by two of the best short-sellers in the business - Russell Clark and John Hempton - who joined us for in-depth conversations on Real Vision TV this year.

Drawing on their wisdom, we'll share some valuable information about how to increase your odds of success and reduce your risk if you'd like to short this frothy market.

First, let's cover the basics. Part of the allure of shorting is it offers the possibility of quick profits. There's a saying on Wall Street that stocks go "up the escalator, down the elevator." In other words, markets tend to fall faster than they rise. Therefore, a well-timed short can often generate larger returns, in a shorter period of time, than being long.

But the possibility of large, quick profits comes at a steep price. Shorting is typically FAR riskier than owning stocks. And we'll be blunt: *shorting is hard*. Consistently profitable short-sellers are as rare as unicorns in the financial markets. There are a few reasons for this.

First, shorting a stock exposes you to *limited gains* but *unlimited losses*. A stock can't drop below zero. But there's no limit to how high any stock can climb. As a result, the raw risk-reward equation is always stacked against a short-seller.

Second, shorting stocks can be *expensive*. When you short a stock, your broker borrows it from its owner on your behalf. Borrowing costs can run as high as 5% - 10%, or perhaps more.

And if a stock is a popular short, the supply of borrowable shares dwindles - which makes it even more expensive to short. As a result, it is very difficult to make money in crowded shorts, simply because the borrowing costs can be prohibitive.

Third, when buying stocks, time is your friend. There are no carrying costs to owning a stock (unless you use leverage). Not so with shorting.

Time is a short-seller's worst enemy. Not only must a short-seller pay the borrowing costs. He's also responsible for paying the dividends. Unlike long positions, you must reach into your pocket every single day to maintain a short position. The clock is always ticking on a short.

"We short things associated with people you would not want to marry your daughter."

These are the words of John Hempton, Founder and CIO of Australian hedge fund Bronte Capital. A highly successful short-seller, Hempton was one of the first investors to publicly "blow the whistle" on Valeant Pharmaceuticals, the infamous drug company that committed massive accounting fraud.

Hempton recently shared his investment process with Real Vision TV. When evaluating securities to short, he takes a "bottom up" approach. This means he targets individual companies with problems or signs of fraud.



"I can find shorts completely and utterly at will," he told Real Vision in mid-November. "The opportunity set at the moment is spectacular on the short side."

This is a big shift from just a few years ago, says Hempton. "In 2011, it was relatively easy to find longs... and it wasn't that easy to find shorts. And now it's really easy to find shorts and not very easy to find longs. So I'm running with that."

This is an important point. Although he's known as an all-time great short-seller, Hempton will flip long or short depending on the current circumstances. This *intellectual flexibility* is one of the most underappreciated traits in all of investing.

If you tend to be a permabull, you'll have a tough time in bear markets. If you're a permabear, you'll have a tough time in bull markets. But if you can objectively weigh the facts and adjust to new circumstances, as Hempton does, you'll have a chance to make money in all environments. This ability to see both sides of the equation is one of the skills that we at Real Vision believe makes a great investor.

Later in his conversation with Real Vision TV, Hempton shared a few "war stories." All were fascinating, but one was downright hilarious.

A few years ago, Hempton and his team suspected that a publicly-traded online dating company was fraudulent. To test their suspicions, they created a fake dating profile of the most unattractive man they could imagine. He was a 620-pound guy who lives with his mother and was infected with, shall we say, severe diseases related to his reproductive organs.

Well, despite this guy's shortcomings, 20 women messaged his fake account and showed interest in dating him. Hempton's team knew they were onto something. They gave this information to the media, and the stock collapsed. If you're interested in hearing the rest of the story in Hempton's words, you can watch the full interview by signing up for a free Real Vision TV 14 day trial [here](#).

Russell Clark, of Horseman Capital, is another renowned short-seller who spoke with Real Vision this year. His approach is totally different from Hempton's, but just as effective.

Clark starts with the big picture view, by analyzing which countries' currencies are most likely to decline. Then he drills down into that country's market and looks for short opportunities. A decline in a country's currency acts as a tailwind that can enhance his returns.

Here's Clark describing his process: "Where a lot of macro guys go wrong is they don't match up the micro with the macro. That's when you get the really powerful moves."

By "macro," Clark means a country's big-picture view. By "micro," Clark means individual companies.

He continued: "If you can find an industry that is really challenged - that is going to drive a macro-type of response and that's when you can make the big bucks."

Like Hempton, Clark hates crowded shorts. As we mentioned earlier, stocks that are widely sold short can be prohibitively expensive to borrow. "One of the first rules of short selling is you've got to find something everyone owns to short. Otherwise it doesn't really make money," Clark says.

Regarding the U.S. stock market, Clark says it looks "toppy" and "expensive." Drilling down, he's most interested in shorting shale oil companies. Both Clark and Hempton agree on this point. They suspect a lot of fraud is taking place in the U.S. shale oil industry.

So how do you execute a short? There are several options.

Generally the least risky way is to short an entire index. Individual stocks can and often do spike 10% or more in one day, inflicting massive and unexpected pain on shorts. The S&P 500, on the other hand, does not experience such big moves; even a 2% one-day spike in the S&P 500 is very rare.

So shorting an index is a good way to “nibble” on a short position without risking a huge loss if the market goes against you. If you’re new to shorting, start with an index. There are a few ways to short an index, but probably the easiest is to buy an ETF that shorts the market for you, like the ProShares Short S&P 500 ETF (ticker: SH). The price of SH rises as the S&P 500 falls. If the S&P 500 drops 1%, SH should rise about 1%.

A warning: you’ve probably seen advertisements for double and tripled leveraged short-ETFs. These promise to magnify gains and losses using derivatives. For example, if the S&P 500 declines 1% in a day, the triple leveraged S&P 500 short ETF should rise about 3% that day.

These products can be suitable for day-traders, but over longer periods of time, they don’t do a good job of tracking the underlying index. So, if you plan to hold a short position for more than a few days, don’t use the leveraged ETFs.

Finally, you may consider shorting the market by buying “put options.” Buying a put gives you the option to sell a given security at a given price by some future date. There’s a learning curve to using options; the mechanics are beyond the scope of what we’ll explain here. But generally, the value of a put option increases as the index it is linked to declines.

There are two big advantages to buying puts. First, it’s very easy to define your risk. You can’t lose more than you invest. Second, puts are quite cheap today. The VIX, which measures the volatility priced into put and call options, isn’t far from record lows.

The biggest downside to puts is that they expire. You have to get the timing right to make money. If you buy puts that expire in March, but the market doesn’t decline until April, you’ll lose money. Also, puts “decay” over time, becoming a bit less valuable each day as their expiration date approaches.

We’ll close today’s issue with this: any short position should be a “high conviction” trade. Generally, the odds are against you when shorting. So it’s best to avoid shorts unless there’s a clear and convincing catalyst to send markets lower.

As we’ve explained, there are a lot of nuances and pitfalls to shorting that make it more complicated and risky than simply buying stocks. Executed correctly, it can be a rewarding way to make profits while others are losing money in a bear market. But as in all of investing, risk-management is key.

If you want to know about this subject, Real Vision’s new flagship interview series premieres tomorrow (Friday 15th). Famed short seller Marc Cohodes joins Grant Williams for a candid and emotionally raw interview about his short selection process.

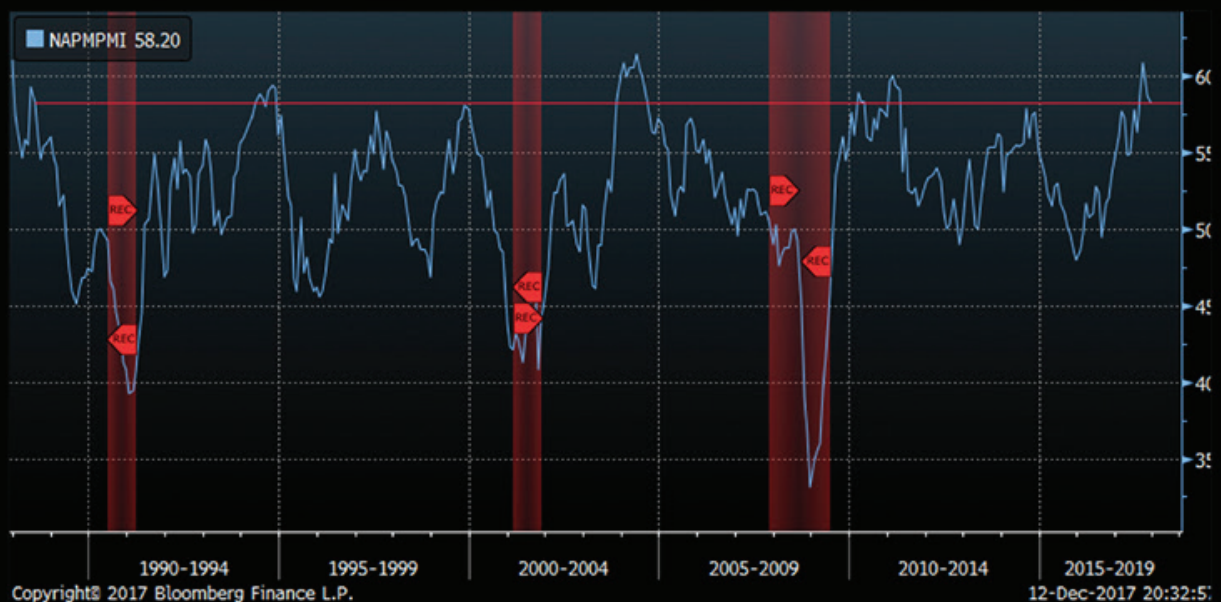
It’s fascinating and you can watch it by signing up for a free 14 day trial [here](#).

See you next week.

IF YOU ONLY LOOK AT ONE CHART



ISM and recessions over the last 30 years. From the current levels of the ISM, it has taken a considerable period of time before the US experienced a recession.



6 DEGREES OF (CONNECTION)

1

WHAT'S WRONG WITH JAPAN'S BANKS?

Japanese stocks have been very good to investors lately. Over the last year, the Nikkei has surged 20%, outpacing other top performing markets like the U.S. S&P (+18%) and the German Dax (+17%).

But it's not all good in Japan. The once-vaunted Japanese banks – which were global titans back in their late 80s / early 90s heydays – are floating dead in the water.

The performance of Japan's largest bank stocks say it all. In the last year, Mizuho has slid 5%, Sumitomo Mitsui has ticked just 1% higher, and Mitsubishi Financial Group has climbed just 8%... all while the Nikkei has surged to 20-year highs.

A NATION OF STAGNATION

2

The poor performance of the bank stocks is a bad sign for Japan's rudderless economy. As we've discussed in previous issues, the Bank of Japan has long tried to spur inflation and growth by injecting massive amounts of yen into the economy. It isn't working. In October, the inflation rate sunk to just 0.2% - just a rounding error away from deflation.

If Japan ever emerges from its low-inflation / low-growth problems, its banks would likely spring back to life. That's why the stagnancy of Japan's bank stocks is such a troubling sign. Stock markets "discount" the future, and tend to lead the economy. If there were any hope of rising inflation in the near future, bank stocks would likely be perking up... instead of lying there dead while everything else in Japan rallies.

3

ONE BANK TO RULE THEM ALL

While the big corporate banks flounder, one bank in Japan is seeing unprecedented growth. Hint: it's the one that can create money from thin air.

As part of its aggressive monetary policy, the Bank of Japan (BoJ) has spent the last few years buying up Japanese financial assets. The result: it now owns a stunning 75% of all Japanese ETFs, and 47% of all Japanese bonds.

Because of the BoJ's gargantuan influence on the markets, traders and investors hang on Governor Kuroda's every word. Indeed, there's a lot of nervous chatter right now about his recent comments that the BoJ may consider scaling back its stimulus.

Markets have grown accustomed to – and some would say reliant on – the BoJ's constant injections of liquidity since 2013. Any change in the BoJ's "full speed ahead" monetary stance will likely shake up stock and bond prices quite a bit.

4

THE INFLUENCE OF THE FED AND THE ECB

Kuroda has good reason to consider scaling back the BoJ's massive stimulus. Up until recently, the U.S. Fed and the European Central Bank were also pursuing aggressive monetary policies. As the kids say, it's OK as long as everyone's doing it.

But recently, both the Fed and ECB have begun easing onto the brakes; the Fed is raising interest rates, and the ECB has begun curtailing its Quantitative Easing purchases.

This is a big deal because, all else equal, loose monetary policy weakens a country's currency. This is less of a problem when all the major central banks are devaluing. But if the BoJ continues its stimulus full bore while the U.S. and Europe tightening? That puts the yen at risk of a rapid, disorderly decline vs. the dollar and euro.

5

A RAY OF HOPE FOR JAPANESE BANKS?

How could the BoJ go about scaling back its stimulus? One popular theory is that it will scrap the cap on bond yields. Currently, the BoJ caps the yield on the 10-year Government Bond at about 0.1%. Kuroda could remove this cap, thus allowing rates to rise.

This would likely cause the yield curve to steepen. Meaning, the spread between short-term and longer-term interest rates would widen. This would be fantastic for Japan's banks, which earn revenue by paying the short-term rate on deposits and lending money out at longer-term rates.

Wider spreads would mean bigger profits for banks. And as we alluded to earlier, Japanese bank stocks have a lot of room to "play catch up" if their financial prospects improve.

A TOUGH DECISION

6

But the removal of the interest rate cap – or any other form of stimulus withdrawal – would have negative effects as well. All else equal, tightening monetary policy should cause the yen to strengthen. This should hurt growth and inflation in Japan.

So if this series of events plays out, the BoJ will be faced with a tough choice. It can tighten monetary policy and allow rates to rise... thus helping banks but likely hurting economic growth.

Or, it can keep cranking on the stimulus, thus hurting the banks and discouraging them from lending. Which also would hurt the economy, in a different way.

It's a catch-22 with no easy answer. We'll be watching closely.



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Ask Milton

question

Mitty,

What's your stock market forecast for 2018?

answer

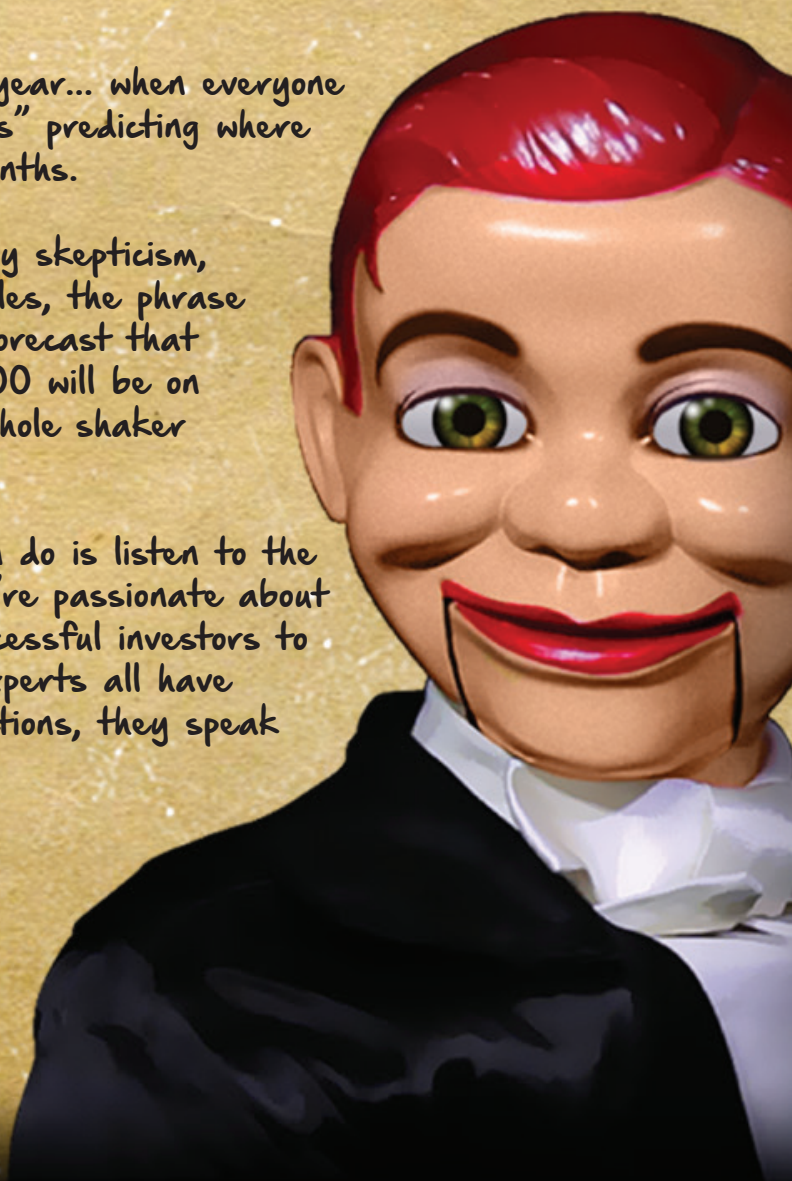
Ah yes. It's the most wonderful time of the year... when everyone and their brother publish "year-end forecasts" predicting where the stock market will go over the next 12 months.

First thing is, no one is clairvoyant. Forgive my skepticism, but having seen more than a few market cycles, the phrase "nobody knows nuthin'" comes to mind. Any forecast that puts a specific number on where the S&P 500 will be on December 31, 2018 should be taken with a whole shaker of salt.

When it comes to forecasts, the best you can do is listen to the best people. As you know, at Real Vision, we're passionate about bringing together the smartest and most successful investors to share their best ideas. You'll notice these experts all have something in common: When it comes to predictions, they speak in probabilities, not certainties.

So what's my forecast? 2018 will be full of surprises that you could have seen coming.

Milton



6xW + 1H

What's hot on Real Vision this week...

WHO

Real Vision co-founder Raoul Pal is joined by legendary trader Peter Brandt, Wall Street guru Nick Colas, and money manager Paul Brodsky, among other financial experts.

WHAT

In a fresh episode of Real Vision's The Big Story series, we ask: How the Hell Do You Value Bitcoin?

WHERE

The exciting world of cryptocurrencies – where stunning price gains are minting new millionaires every week.

WHEN

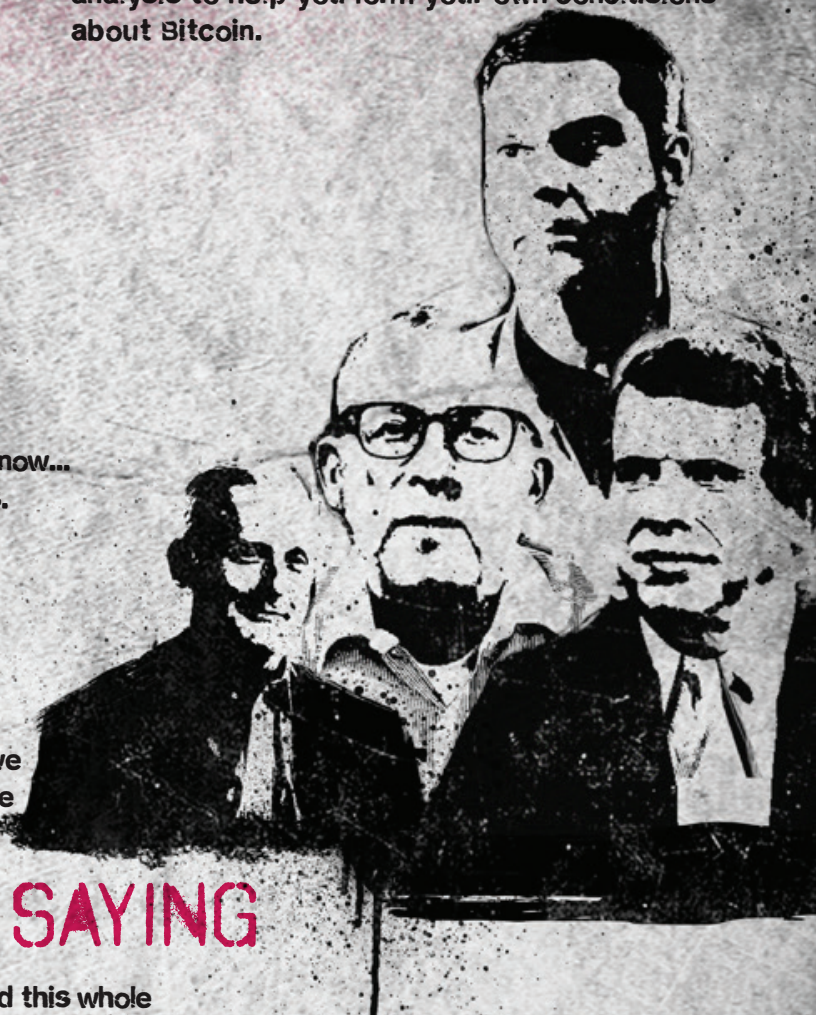
We look at what's taking place in the Bitcoin world right now... and get our experts' thoughts on what's in store for 2018.

WHY

We're witnessing history. Having gained more than 1,800% this year, Bitcoin is in a bull market for the ages. With a single coin now fetching over \$16,000, we ask a hard but important question: how do you place a value on Bitcoin and other cryptoassets?

HOW

Raoul Pal speaks with several experts, each of whom bring a different perspective. Some believe Bitcoin is worth many multiples of its current price. Others, like chartist Peter Brandt, believe it will eventually lose 50 – 60% of its value. This film is bursting with top-notch analysis to help you form your own conclusions about Bitcoin.



WHAT PEOPLE ARE SAYING

"Very informative! I've been trying to wrap my head around this whole crypto/blockchain world and this helped a lot. Thanks." – SUBSCRIBER RICHARD M.



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