Ten Seconds Into The Future 2010

In a simple world, we eat what we kill today, we consumer what we produce today. With trade in its simplest form, barter, we are able to specialize and be more efficient, focusing our talents and gifts on what we have an advantage in. The invention of money, whether gold or fiat currency, allowed us to grease the wheels of trade. The invention of credit allowed us to trade with the each other and the future, allowing us to consume what others have produced today and pay for it with what we produce tomorrow, accounted for in some convenient measure of currency.

Note that the uncertainty over one's ability to produce tomorrow translates into one's inability to repay and hence impairs one's ability to borrow to consume today. Imprudent financial management will also impair the ability to repay and hence the abiltiy to borrow.

For the last decade, the West has clearly over consumed and over borrowed. This has been financed by savings in the developing world. From a flow and stock perspective, this is unsustainable, as has been demonstrated. While the credit crisis of 2008 has exposed imbalances and corrected a few, the more fundamental issue of savings and consumption is still being resolved and could take several years to unfold.

The chronic indebtedness of individuals was always unsustainable. At some stage, like now, the government would have to step in to bail out the consumer. As consumers or Main Street rails at Wall Street, thought should be given for the role the consumer played in the origination of credit in the form of mortgages, credit card loans, auto loans, which were securitized and structured for trading. The only politically viable short term or even medium term solution was to transfer most of the private debt onto the public balance sheet.

A combination of financial system rescues, emergency fiscal spending, falling tax revenues has resulted in serious degradation of public balance sheets, in some cases threatening liquidity and in others solvency of sovereign issuers.

Developed countries will spend the next 5 to 7 years reducing their indebtedness across public and private balance sheets. Developing countries will be doing the reverse. **The relative value lies therefore in developed countries' sovereign debt relative to emerging market debt.** This is of course dependent on current pricing as it can be an expensive trade to carry.

Inflation is likely to impact the emerging markets disproportionately given the composition of consumption baskets in developed markets versus emegring markets.

Developed markets are likely to continue operating relative loose monetary policy. Inflation is less of a problem for them. Inflation comes from two sources, internal and external prices. The recent weakness in GBP and EUR will introduce inflation purely mechanically from an accounting perspective. The other source is from internal inflation from capacity constraints. The latter does not appear to be a source of concern. Rich world capacity utilization has only barely approached 2001 recession levels and this after a year long recovery.

Inflation will likely be very product market specific. **Inflation is indiscriminate only in cases of hyperinflation where the trigger is a loss of confidence in a currency rather than a continuous erosion in purchasing power.** Absent a loss of confidence, inflation will likely only affect capacity constrained product markets, and may just as easily also manifest in asset markets. This is stating the obvious but directs the search for inflationary areas to capacity constrained areas. Commodities like gold are obvious markets which are likely to see inflation, although in the particular case of gold, its increasing use as an inflation or risk asset hedge is likely to introduce linkages to the risk assets it is intended to hedge, degrading its utility as a hedge. Land and real estate are other areas where particular capacity constrained locations and asset types are likely to see inflation. Ags and softs are complicated by the noise introduced by technology, weather, access to water, regulation and policy.

In indebted countries, policy will lean towards creating inflation. In less indebted countries, policy will lean towards price stability. Aims and results are different things. **Short rates are likely to remain low in developed markets** as their economies remain weak and policy will lean towards growth rather than inflation. **The reverse is likely to be true in emerging markets** where the same inflationary pressures will have more severe wealth effects and policy has to be more hawkish. At the long end, rates are expected to remain high for both emerging and developed countries reflecting both inflation expectations and balance sheet strength.

As the balance of savings mean reverts between East and West, trade imbalances will also mean revert towards balance. The impact on FX is likely to bring **strength to EUR and USD** and weakness to JPY (and CNY, BRL, AUD). This is quite a long term theme likely to be subject to signficant volatility.

Globally, as represented by the MSCI World Index, **stocks are cheap to credit and fairly priced to Treasuries**. Given the inflation outlook and the outlook for credit quality of sovereigns going forward, stocks are preferable. Geographically, stocks are fairly priced on a relative basis. The Dow trades at a 4% yield gap to treasuries while Shanghai and Bombay trade at 2% yield gaps over US treasuries and at 2% and -2% gaps to local respectively. The Hang Seng interestingly is at a 4% gap to US treasuries and to local HKD. Australia trades at 2.7% over UST and flat over local, Canada trades at 3.3% over UST and 3.5% over local, just as a rough guide.

Simply buying and holding equities is insufficient. Indices hide a multitude of data issues such as survivorship bias. In the last 100 years, only 1 stock has remained in the Dow Jones Industrial Average, General Electric. All the other components have changed, merged, fallen away. Stock selection is important. Stock selection per se is an established and valuable way of generating returns. Stock selection is also important as a means of more intelligently representing broad macro views.

The theme of growing domestic consumption in emerging markets such as China, India, Brazil and Indonesia is a long term theme that had been brewing since before 2008 and continues to hold. The developed world will increase its savings rates simply and mathematically based on the dearth of de facto vendor financing – the over saving of emerging market consumers and their central bank purchases of US treasuries.

The developed world is steadily becoming a net exporter. The emerging markets will steadily become a net importer. This hides a multitude of detail and colour, however, the basic message is to buy developed world exporters and short emerging market exporters, to buy emerging market domestic plays and short developed market domestic plays. World trade will rebound, only the net direction will change. Container ships which were empty to Asia and full to the US and Europe are likely to reverse that phenomenon. The developed world has much to offer: high tech, intellectual property heavy products and services, and brands and franchises such as luxuries. Emerging markets will with time develop their own intellectual property to the level of the developed world but this will take time. They may be better at commercialization of developed world technologies for distribution to a domestic client base.

Emerging markets have been chronically starved of credit relative to developed markets. Barriers to entry to international banks are unlikely to fall quickly. They will more likely erode with time and consolidation. In the meantime, the acceleration of emerging market growth on the back of a globally coordinated quantitative easing, transmitted through sclerotic developing world capital markets and de facto currency pegs and managed floats, is unlikely to find credit capacity from the domestic banking systems, and the peripheral access afforded international banks. There will be an undersupply of capital leading to an undersupply of credit. **Emerging markets need and will develop, a shadow banking system.** The sophistication of Western central banks and financial market regulators was insufficient to control the growth of the shadow banking system, allowing it to grow out of hand in size, complexity, and audacity, to the extent that it became an integral part of the credit crisis of 2008. What is the probability that less experienced, granted, no less shrewd regulators in emerging markets will be able to guide and regulate the new shadow banking industry as it evolves on their patch?

The obvious opportunities are to replicate the bubble inflating strategies in the US pre credit crisis adjusted for local particularities. Spread compression, cheap and excessive leverage, real estate, LBOs, M&A, levered loans, securitization, structured credit. History will not repeat itself precisely, but the plot devices are likely to be the same.

The implications of emerging market populations not only converging to developed world per capita ouput, but also in their levels of indebtedness and the concomitant credit creation are profound. Inflationary pressures will be significant both in the real economy and in asset markets. The prognosis for emerging markets in the long run is positive. The risks, however, lie in the way the 2008 credit crisis has been addressed by Western governments and regulators. Many inefficiencies and imbalances remain unaddressed, moral hazard being foremost among them. But that will be somebody else’s’ crisis.