

Economic Recovery or False Dawn

The US economy consolidates its economic recovery while Europe slips into recession. China eases as its economy cools and the rest of the BRICs begin to loosen policy to bolster slowing growth. Amid this landscape, equity markets and other **risky assets have rallied**. The surge has been concentrated in the BRICs and in the cyclical and previously distressed corners of the global economy such as banking and consumer discretionary companies, especially luxuries. Defensive companies with stable and predictable cash flows have lagged.

The **LTRO of the ECB**, surely a sign of the weakness of the European banking system and clearly dilutive of the Euro have sent both European bank shares and the Euro surging. If one understands the psyche of the investor, more, of humans, this is to be expected and was envisaged in my article of mid December 2011 when the ECB had just cut its refinancing rate by 50 bps and announced its 3 year repo. It was as if the ECB provided a massive dose of morphine and suddenly the corpse sat bolt upright, and people thought this was a good thing.

I have never purported to be better at forecasting or predicting the future prospects of markets than the next drunk at the bar. But I always have a thesis, supported by signposts which serve as the evidence as time unfolds, and I am impatient with losses and patient with winnings. I'm probably right half of the time. That's life. This is a bit of a warning to all who read these articles. There are times when I have stronger belief in my own expectations and times when I have less conviction.

Look at the world today. Apart from the US, **the world economy is slowing**, dangerously so in some areas such as Europe. Even the BRICs are slowing. The US economy's recovery is a lagged effect from China's voracious appetite for Keynesian fiscal railway track building. That and an out of phase inventory cycle which is likely to drive US manufacturing for another 6 months.

But the future is very much unclear. This is no way to write an investment article but it's the truth. We often sound more confident than we are. We are so used to behaving like that, especially with other peoples' money. But now the stakes are especially high. Investors, wrong footed by the December LTR0 which they grossly underestimated in size and market impact, now expect the Feb 29 LTR0 to be 2 to 3 times larger than the 489 billion EUR of the previous one. They might be disappointed and at risk of being whipsawed. I do not see the collateral accumulation in the MRO or short term 1 week repos these past weeks as I saw in the run up to the Dec 22 LTR0. **The market impact if the Feb LTR0 is below the expected size might be quite bad.**

While the US looks to be in recovery there are always mini cycles within the longer term cycles. The colossal **Federal debt is a problem** for the US. At 15 trillion USD it outstrips US GDP. It is remarkable that sovereign debt has effectively become PIKs (payment in kind), a type of financing reserved for cash strapped and highly geared borrowers, which of course actually makes sense. The fiscal drag for the next decade is ominous. Somehow money has to be found to pay down existing debt and to cover medical care, pay for pensions for the aged, maintain military infrastructure, provide for unemployment insurance, fund education etc etc. All this at a time when the banking system, globally, is going through a process of restructuring existing assets as well as restructuring the standards of future credit provision.

If banks have been given a reprieve, it is **not a long term solution**. Now that the frailties of fractional reserve banking have been exposed, and patchwork solutions such as Basel III have been introduced, how will we get capital, money, from over here to over there? Central banks have liquefied the banking system with massive loans at artificially depressed costs in the hope that this money will find itself into the hands of enterprises and households so as to fund economic growth and consumption. Capital requirements whether under Basel or local regulations deter banks from lending to all but the highest rated borrowers, even if these borrowers turn out to be deadbeats. Healthy, cash flow generative private businesses may not find it so easy to borrow. Households may not find it so easy to refinance their mortgages, or get home equity loans or lines of credit.

If banks were meant to de-leverage their balance sheets, they certainly have a strange way of doing it. Tier One Capital Ratios are still widely seen as the metric

of financial stability even as the problem assets carry a zero risk weight while healthy corporate assets carry a full 100% risk weight. With the provision of credit from the central banks, banks have chosen to shore up Tier One Capital ratios by **loading up on sovereign bonds** while eschewing more capital intensive corporate loans. In this way, commercial banks are co-opted into monetizing sovereign debt on behalf of their central banks. Artificially depressing interest rates and inflating asset prices are excellent strategies in debt management. The trick is in sheltering the inflationary pressures from public scrutiny. This two pronged strategy of regulation and credit extension also drives a direct substitution away from private credit provision towards quantitative easing and is a perverse example of **crowding out at low interest rates**.

Since 2008, **China has been a major driver of global economic growth**. The fortunes of Latin American and Australian resource companies, of German equipment manufacturers, of US brands and intellectual property owning companies, of European luxury purveyors, can be traced ultimately to a credit induced, infrastructure investment binge driven spurt of economic growth from China. The restructuring of China into a more balanced consumption driven economy has been slow. The acute income inequality does not help. Until the distribution of wealth is more equitable China will remain an investment and government driven economy. The Keynesian policies have already driven up inflation and despite a slowing of top line CPI growth, **food prices remain stubbornly high**, confounding government efforts at reflating a slowing economy. With an upcoming change of management at the top of the Party, China's policy makers are faced with addressing inflation, managing the massive credit creation in the shadow banking industry and keeping economic growth sufficient to absorb new entrants into the labour market. Short term considerations will likely force China into further infrastructure investment. Any ideas about investing in resources should be tempered by the massive stockpiles that the Chinese have accumulated directly and indirectly.

And then there is just the total debt including unfunded public liabilities globally. **There is simply too much debt in the system**. Focusing just on the US before turning one's attention to Europe and Japan, is enough to discourage the most bullish investor. Total Federal debt is roughly 100% of GDP, that's 15 trillion USD. Private debt is over double that. So all in we are looking at over 300% of GDP. The Federal debt needs further adjustments for social benefits and healthcare which add

another 50 over billion USD to the bill. And soon we are staring at public liabilities alone of over 300% of GDP. **The USA's debt to GDP ratio stands at over 3.5X.** The numbers in Japan are similarly poor. Public debt is circa 200% and while we are told that this is not a problem because it is domestically funded, it is a huge fiscal drag and an accident waiting to happen. Private debt in Japan is over 300% of GDP, down from almost 400% in the late 1980's when Japan's bubble burst. The impact of debt on Japan is clear to see; decades of slow growth and stagnation. And in the UK and the Eurozone, the situation is worse than in the US. The way in which GDP is measured results in debt financed expenditure being counted in the national income accounts as GDP. If then we expect that debt levels need to be reduced then we should also expect muted if not falling GDP in the future. High debt levels also encourage savings, at least in the private sector where unlimited credit growth is not viable.

To summarize these random and highly equivocal thoughts:

- The rally in risk assets is liquidity driven. Long run fundamentals remain in acutely poor condition.
- Each central bank will attempt debt monetization and stoking inflation to the extent that they can.
- Each country will try to debase their own currency in rounds of rotational devaluation.
- It is not a long term viable solution to solve a debt crisis with credit creation. This is analogous to attempting to extinguish a fire with gasoline.
- Long term debt reduction is the only viable solution not to create more booms and busts.
- The US recovery has another 3 months or so to run. Beyond that we have no visibility. It is likely to stall.
- Europe is likely to remain in recession for some time despite liquidity infusions.
- China will concentrate on local issues until the handover is complete. Political sensitivities such as food price inflation come first.
- Resource economies may benefit from further infrastructure investment by China but given the volatility of this single oftaker and current stockpiles, this is a risky bet.

- The current rally in risk assets is not expected to extend too much further.
(Japan's stimulus may drive Japanese equities a bit further.)

The long term is not so relevant from a trading perspective. And the forecasts and expectations need to be discounted with a higher level of uncertainty the farther we look out on the horizon. My gut feel is the following:

The risk surrounding over optimistic expectations over the ECB's LTR0 could hurt risk assets. I would not hold a large net position, in fact I would not hold a large gross position over the next 2 weeks. The market has swung from a heavily oversold position at the end of last year, and an acutely pessimistic view, to an unreasonably rosy view of economic growth in the BRICs and recovery in the US.

Over a slightly longer horizon, say 6 months, I expect the lack of diabolically game changing good or bad news to maintain the status quo of uncertainty, thus also maintaining the upward pressure on risk assets. Reality is likely to rear its head later in the year once equities have reached higher valuations. A US Presidential election looms, the changing of the guard in China has already begun, Europe's political landscape may change as economic issues spill over to the political landscape. All these complicates matters. I expect weakness in risk assets to set in only in the latter part of the year. In the meantime, the only viable strategy is NOT to buy and hold, but to actively trade, as much for profit as to manage exposure and risk.

At the end of the day, I too struggle in the fog of uncertainty as I try to cope with each piece of news and each new development. I wish my crystal ball was Baccarat and not Lalique.