Current Concerns In The World Economy

What are investors worried about? There is a lot to worry about but there are usually two to three factors that really drive sentiment.

The G20 summit has brought the relationship between China and the US into the spotlight. The concerns extended beyond currency wars and trade protectionism to strategic and geopolitical issues.

The inflation deflation debate remains unresolved.

The suitability and effectiveness of a second round of currency printing dubbed QE2 remains undecided.

Sovereign risk in Europe has resurfaced since it first emerged in May with Irish, Spanish and Greek sovereign CDS spreads widening again.

So, lots to worry about.

However, markets don’t rise in a straight line. Neither do they fall in straight lines.

I certainly don’t have all the answers. Or even many of them. But I do have some.

European sovereign I know little about. In an earlier post I considered the position of an investor looking at sovereign debt purely as an investment where I thought that the investor is only interested in two things, the purchasing power of the asset in its domestic currency and the purchasing power of the same asset in the investors’ currency and the value of these two measures in a debt restructuring. We know that debtor nations will almost certainly engineer inflation and attempt to debase their own currencies so as to minimize the value of the assets to the investor in all their relevant measures. Investors recognize this and thus adjust the premium they require in compensation.

Why are US treasuries different? During and immediately following the crisis US treasuries were demanded as a risk free asset. This was the right strategy if the objective was risk aversion. Why are US treasury yields so low? QE and QE2 are the other reasons. Even if no one else will buy US government debt, the US Federal Reserve will. Distinguishing between planned and unplanned quantitative easing will be an interesting exercise.

Inflation and deflation I have also dealt with in an earlier post. Inflation is everywhere, even in the US. It just hasn’t been detected because of how the CPI is constructed. Owner equivalent rents (27% of CPI), lower rents, lower mortgage rates and a weak housing sector are artificially depressing the official inflation numbers.

Which brings us to China US relations. The risk here is more strategic than commercial, although economics plays an important part.

The US points to an artificially low CNY threatening US competitiveness and sustaining an acute current account imbalance.

China points to QE as being dangerously inflationary as capital floods inwards from the Fed’s printing press.

Both sides have their points and therefore a compromise is the efficient solution. Whether we get compromise is another matter, and it is a matter not for economists but for politicians. This is the greatest worry.

Both the US and China have pockets of insularity and nationalism which could destabilize the symbiosis that defines their relationship. And the rhetoric from both sides is not encouraging.

China needs to understand that the US being a democracy is hostage to populism and special interests, which could confound the more rational policy makers.

The Americans need to understand that the Communist Party is a labyrinth of politics and that their counterparts in government may be as constrained as they are domestically, hobbled by conservatives and nationalists advancing their own agenda.

The issues are not just currency. One suspects that a free floating CNY might not necessarily strengthen. One can imagine that the PBOC’s diversification program of reserve management is reducing demand for US treasuries that might be inducing unplanned quantitative easing. This theory supports China’s rampant demand for natural resources.

Militarily China will take years to match the US but the build up has begun. Interestingly this build up has little to do with challenging the US as a world power. Like all empire building throughout history it stems not from ambition but from necessity, the need to protect its own interests, which for the moment thankfully lies in Africa and is at little risk of bumping shoulders with the developed world. Asia has more to fear from China than the US and cleverly the Americans have responded to that fear with friendly gestures to India, Japan and ASEAN.

These are some of the fears that plague the markets. Will they ultimately induce a bear market? Stocks are priced nominally and money printing lifts all boats. Volatility will probably rise but I do not see a bear market unless the political and strategic concerns precipitate some sort of commercial or trade conflict which hits the bottom line of companies. In the meantime, happy trading. This is not the time to be passive.