Prospects For A Wounded Economy: 2H 2011

It is never a trivial exercise to guess the direction of markets and asset classes. The best investment managers barely get it right more than half of the time. They make money because they are tactical and quick to cut losing positions and let winners ride, or they find trade expressions which give them an edge such as where there is convexity, or they find arbitrage opportunities where they build in their edge structurally. With that in mind, I will venture into speculation.

Sentiment has improved once again. A number of factors have contributed to this:

- A possible Greek sovereign debt default has been averted. The solution is neither perfect, nor sound but it is adequate for Europe's purposes for now.
- China has announced victory over inflation and represented that it has successfully engineered a soft landing.
- The US economy while it has weakened significantly in the last quarter appears to have some bright spots, notably in the ISM numbers.
- The rate of decline of the US housing market looks to have stopped accelerating.
- The Fed has called to a close QE2 and has not seen the need for a further round of quantitative easing.
- Oil prices have fallen from recent peaks to more manageable levels in the low to mid 90's.

Sentiment alone can carry equity markets and risk assets a few months, call it 3 at the most. And it can still easily falter much earlier than that. Thereafter some fundamental or liquidity reasons are needed to sustain any rally. So let's try to find some fundamental or liquidity support for risk assets.

Which of the problems from before 2008 have been resolved or addressed adequately?

- The US housing bubble is still deflating. There is little that the government can do except buy time. Or buy houses. The latter strategy is not as ridiculous as it sounds but will likely face considerable political headwinds. Otherwise, employment and wage growth are necessary conditions for a housing recovery and prospects for both look muted. Two years to a recovery seems to be a reasonable time frame. Without a recovery in employment there is no recovery in housing. Without a recovery in housing, there is no recovery in domestic consumption. The US needs to become an export economy.
- The world is still in deleveraging mode. The deleveraging process has been a complex, path dependent one where leverage has been passed from private to public hands with little paydown or restructuring. In the interim, efforts at releveraging have punctuated the deleveraging. This is no way to manage a deleveraging process. Policymakers have completely overlooked the necessary symmetry of the market mechanism and seek solutions which avoid allocating any form of pain to any constituency of the economy. The taxpayer is not a constituency, it is everyone, and so the strategy represents a socialist redistribution of the damage.
- The Euro clearly imposes differentlal pressures on the different member countries' economies. Greece's problems are not entirely due to 2008 but are symptomatic of a more fundamental inefficiency. The temporary solutions sought for Greece's debt refinancings indicate no recognition by the EU of the inefficiencies imposed by the Euro. The Greek saga is by no means at an end.
- Commodity inflation is a secular trend interrupted by the recession of 2008. The commodity curves show that commodity price inflation is fundamentally supported and not speculative. The inflationary pressures are therefore expected to persist since no concerted solution has been sought.
- China's credit expansion in response to the 2008 crisis, investment in infrastructure, has been largely funded by credit which has resulted in a surge in credit creation in 2009 and 2010 via SIV like conduits (LGFVs). The government's efforts to rein in credit in 2011 has apparently addressed these conduits, however, due to the opacity of the market, risks remain, especially given that assets are long term infrastructure debt while liabilities largely consist of retail short term credit linked investment products. The resolution remains to be seen. A recent inspection of Chinese banks' CDS spreads is not encouraging. It was estimated that the size of the

LGFV market totaled over 2 trillion USD.

- Underfunded pensions in the Western world. This is a chronic problem from over 10 years ago which was unfurled in the aftermath of the 2000 recession and which drove pensions into yield, the arms of structured credit and fictitious or more appropriately, imaginary investment grade paper.

It appears that no long term solutions to any of the problems have been sought and that policy has so far been aimed at addressing symptoms rather than underlying fundamentals. The result of this is likely to be increased volatility as each solution to a specific symptom peters out and imbalances find new m
anifestations. In other words, we face a very interesting sentiment, psychology, liquidity and event driven market over the next few years.

We noted that sentiment had improved and that a 3 month rally in risky assets is possible, but is it probable? All speculation of course. Absent government efforts to create a liquidity driven risky asset rally, operate inflationary policies and currency debasement, the reality of the underlying economies should depress markets. The only rational reason that governments have paused such policies is because the market recognizes the funding constraints for sovereigns in pursuing this policy. The market recognizes this in the form of increased reported headline and core inflation, in sovereign credit spreads, in the levels of sovereign debt issuance, on the structure of demand for such government debt and in the forward borrowing requirements of governments. Without these constraints, governments would be diligently printing money and creating inflation.

My best guess:

- The momentum from the recent spate of good news will be short lived. Broad based net long exposure will not help.
- Governments will not be able to resume stimulus due to tight balance sheet constraints.
- Economies have decoupled. Buy the China plays listed and domiciled abroad. Continue to short the China exporters. Note this is quite a stale trade but it has legs. However, if a credit crisis surfaces in China, all bets are off. Keep a close eye on the Chinese shadow banking system. The new

exporters from the US to the emerging markets need to be identified (easier said than done.)

- Treasuries will resume their yield compression on bank buying pressure – QE3.
- Agricultural commodities and their derivatives and equities are likely to remain supported. This is simply the resumption of a long term secular trend that was interrupted in 2008. The decoupling between developed and emerging markets is likely to boost secular demand. A slowdown in China and a very weak recovery in the US is unlikely to support the industrial commodities. While the forward curves for industrial metals look strong today, this is probably a lagging indicator and weakness is likely to set in later.
- There is a significant risk of another credit crisis, so trade with caution. The Greek solution is not a good solution. It is a bailout not of the Greek economy but of the Western European banks. A voluntary (sic) exchange offer is not a solution to a poorly run business or country. The fundamentals of the Greek economy require a repricing which the Euro effectively precludes. Contagion risk dominates solvency, particularly where sovereign solvency is concerned because of the problems with defining the assets of the sovereign, namely the capitalized value of the tax base. The level of Chinese debt in off balance sheet vehicles is also worrying especially in light of the opacity and compromised corporate governance associated with Chinese businesses. The US economy still looks recessionary although there are signs that a recovery may be a real prospect in the next few quarters.

We are not out of the woods.