

Ten Seconds Into The Future

Wait. Worry. There is never an easy time to invest but it is a convenient and effective excuse for those who invest or trade in fear and ignorance.

In the 80's we worried about inflation and recession, the aftermath of the S&L crisis, the Latin debt crisis, an escalation of the cold war. In the 90's we worried about the Euro, recession in Britain, a devastating earthquake in Japan, inflation in the US, economic crisis in Asia, the solvency of Russia, systemic failure in the death throes of LTCM, and Y2K. In the 2000's we fretted over the bursting of the Internet bubble, recession in the US, terrorist threats, trade imbalances, leverage in housing markets, the great financial crisis, the survival of capitalism as we know it, depression, deflation, inflation, and sovereign default.

Worry is what we do. Crises are normal. Some of the reasons are behavioural and unavoidable, but others are of our own construction.

Today we worry about sovereign default in peripheral Europe, the state of the Japanese economy, the future of MENA, and the impact on the flow of oil, and of course inflation.

The fact is that the Euro was a singularly poor idea. In a single act, one major degree of flexibility for price adjustment was taken away from an entire region, requiring price adjustment to occur locally, and if not, to result in sub-optimal price signals and allocations. A single currency also imposed a single monetary policy upon a region of diverse fiscal regimes and potentially out of phase economic cycles. The current fears of sovereign default, inability to reach consensus over policy, political instability both in the periphery as well as in core Europe, are but symptoms of a more profound inefficiency: that one size does not fit all in Europe.

The political situation in MENA is a quagmire. The European intervention in Libya, nominally to protect Western interests but also as a matter of principle and humanitarian sensibility (so perverse have the local politics of financial and fiscal stress become), is lacking a clear exit strategy or metric of success or failure. In MENA repression and inequality of wealth are endemic accumulating pressures for revolution. The Arab, regardless of whether a have or have not, will tell you that revolution has been a long time coming. Were it not for the importance of MENA to global oil supply, no one might care but oil is now trading at over 100 usd per barrel and could become a drag on economic growth.

Fears of deflation in early 2009 turned to fears of inflation in late 2010. The inflation stemmed in part from rising agricultural commodities and food prices, a resumption of the secular forces in dietary trends in emerging markets, weather volatility, from rising oil prices due to the political unrest in the Middle East and North Africa, as well as from the global concerted efforts at quantitative easing now in their third year. The emerging markets have been quicker off the mark to address inflation with higher interest rates while developed countries have kept interest rates firmly to the floor to prop up their insolvent banking systems. These countries, the UK, the US and the Eurozone now risk stagflation.

The earthquake and subsequent tsunami in Japan has profound effect on the global economy. Domestically, it is expected that the immediate effects on the Japanese economy will be negative but transient and that the rebuilding of infrastructure will drive growth in the second half of the year. This seems to be the consensus. Externally, Japan has been a shrinking marginal participant in world trade and it is therefore argued that the impact of a slowdown in Japan is unlikely to be felt elsewhere. However, the importance of Japan in the global supply chain should not be underestimated. Japan is an important link in the chain in technology and a supplier (sometimes a sole supplier) of key components in many global manufacturing processes. The estimation of the true impact of the disruption requires a micro analysis of the affected industries. We know that in the auto industry Detroit and Frankfurt have faced severe disruptions to key components in fuel management systems.

A risk that has not yet been addressed is inflation in the US, where official inflation numbers appear benign but may in fact be mis-measured. The mis-measurement

of inflation can lead to a mis-estimation of real GDP growth, potentially masking a current or impending US recession.

Then there is the problem of bank balance sheets. The stress tests that marked a turning point in the financial crisis were largely self assessments made by an industry whose reputation for integrity is in question. That banks have been repeatedly recapitalized and re-liquefied and yet have failed to convincingly return to normal propensities for credit extension must arouse some suspicions.

A broader and more general observation must hypothesize that the 'goldilocks' economy of the 1990's was due to the 'export' of inflation through the offshoring of productive capacity allowing a lower NAIRU. The consequence of the successful pursuit of this strategy must necessarily be an increasing current account deficit. A reversal of the current account deficits must also imply a return to a more natural NAIRU, a higher one.

What it also means is that long term interest rates are likely to be higher for longer. This is not necessarily a bad thing as long as interest rates are endogenously determined and not the product of a unilateral effort to finance government or the operation of a deliberately inflationary debt management strategy.

Unfortunately there are no trading strategies that immediately arise from the above observations. However, markets remain liquid and normal and provide the tactical trader with ample opportunity to make and lose money in equal measure. Good luck.