Ten Seconds Into The Future 2011 06

A peek at the future seen through a cracked and hazy crystal ball…

The US economy is in recession. The US economy had been supported in the past year by large scale debt monetization and concomitant Fed balance sheet expansion. The absence of monetary expansion has exposed the fragility of the recovery. That the economy is in recession does not imply falling stock markets but it does apply downward pressure. Expansionary monetary policy can and does increase the nominal output in any market including goods and asset markets. In capacity constrained markets, prices are likely to rise.

QE3 may already be underway. As the Fed ends its program of buying treasuries, volatility has returned to markets and the economy. Commercial banks have been buying US treasuries and are likely to step up purchases for a host of reasons among which are the continuing fall in house prices which formed the largest collateral base for US bank lending, Basel 3 rules for risk weighted capital which continue to rate US treasuries as zero default risk and therefore carry a zero risk weight, the ability to borrow at the short end at near zero rates and lend to the US government at 3%.
Interest rates across the yield curve likely to be capped at current levels. And may head lower at the long end. The US economy is in no condition to face higher interest rates. The mortgage market requires lower long rates. The short end is pinned at zero lest the Fed trigger another banking crisis. The USD yield curve is likely to continue flattening for the foreseeable future.

Asian Real Estate is likely to remain supported. In the near term, local factors will weigh on real estate in HK, China and

Singapore, likely precipitating a correction. However, in the longer term, with G3 interest rates close to zero and the likelihood of further central bank balance sheet expansion, the prospects for liquidity driven real estate bubbles remain good. Watch out for the volatility though.

Commodities are likely to continue to rise. Emerging market growth may weaken in response to a US recession but domestic economies are strong. Emerging market manufacturing is an inefficient user of resources and for a given level of growth can be expected to consume more resources. Commodity markets were less contangoed and more backwardated pre the sharp correction in May which is indicative of fundamental demand versus tight supply. Buy on weakness.

Equities cannot be called as a group. The Short Term. The short term outlook is uncertain but certain trends are tradable. Consumer stocks have done well and are due for a correction in a sector rotation. US and European exporters with Asian and Lat Am customers have done well and are also likely to be rotated out of in a derisking. Luxuries will likely stay supported relative to staples and lower price point cyclicals. Buy food and beverage whenever margins get compressed like now, hold them through till margins normalize as they always do. The same goes for insurance companies. The Japan quake has been a significant cost to insurance companies, however, premia are bound to rise and will be accretive until the next catastrophe. Do watch the exposure to Greek debt, however.

Equities cannot be called as a group. The Long Term. The long term outlook requires stock picking to express both fundamental as well as macro opportunities. With the state of Western economies as they are, the most likely outcome is that they attempt to export their way out of their recessions. As an economy gears itself for exports, currencies are usually depressed, investment tends to rise as the economy retools itself, but it is not always clear what sectors emerge as export engines. Europe will for a long time be the supplier of luxury goods to the rest of the world. Barriers to entry are high and this is unlikely to change. Germany's preeminence in high tech engineering can be eroded by emerging market competition. The US will continue to export capital goods. Buying Caterpillar on weakness may not be as lucrative as China's development evolves away from infrastructure driven growth. The US does have some luxury and lifestyle brands to export to the emerging markets. Over the longer term, barriers to entry are important. The billion dollar question is: what can the US make that the rest of the world wants to buy?

Equities cannot be called as a group. Finance. Emerging market growth is expected to remain buoyant. There may be headwinds coming from the developed markets but emerging markets have clearly decoupled at the fundamental economy level. The emerging market banking systems, however, are unlikely to have sufficient capital under Basel 3 to finance their own economic growth. There is an opportunity for non-bank financials, leasing companies, direct lenders, mezzanine hedge funds, to step in to fill the financing gap. Emerging markets growth can benefit from the growth of a Shadow Banking system.

Greece is cash flow insolvent. And the asset side of a sovereign balance sheet is not well defined. Greece's fiscal problems did not stem from an asset bubble or a real estate boom. Greece has run structural deficits which would have culminated in a crisis even if the financial crisis did not happen. There are no easy solutions for Greece. There is a risk that the people of Greece may decide against facing austerity and choose outright default much as Iceland did. The EU is desperately trying to bail out not Greece but their own banks with Greek sovereign exposure. Greece is not important enough to the EU otherwise to bail out. With little or no exposure in French and German banks, Greece would have been ejected from the union by now. The debt overhang will foreshadow the European banking system for some time to come.

Trade it if you dare but be ready to bail.

Gold is not worth anything, but everything else is worth even less. Gold has no economic value in that it cannot be used for anything. For that reason there are no valuation methodologies for gold except that it is worth more in the minds of investors than other things. For this reason alone, if the hypothesis about further debt monetization is correct, the price of gold is unbounded above.

Liquidity is worth more than gold. In times of uncertainty there is no better asset than optionality and there is no better option than liquidity. It should be clear that the problems of 2008 were never addressed properly and that most of the problems have at best been transformed from one form to another. The level of debt in the global economy remains a chronic problem which has yet to find a solution. Attempts at inflating it away have only just begun and will take time to take hold. In the meantime, expect volatile markets, not so much measured in traditional measures of volatility but in the form of strong time local trends. These trends are tradable but one needs dry powder, in other words, cash. If not cash then a combination of liquidity and resolve. Liquidity to go to cash, and resolve to buy low and sell high. There is no better time to buy assets than when there is a big problem in the economy or in the markets. Macro and trading hedge funds can take advantage of such variability in markets and sentiment.

Inefficient market pricing is worth more than gold. As the world goes through post crisis oscillations and policymakers attempt to dampen the cycles, mispricings in markets occur. Empirically, the more the intervention, the greater the mispricing opportunities. In addition to mispricings, one can expect large swings in markets. Having a liquid portfolio allows one to take advantage of these big swings, provided, and this is a crucial caveat, provided one has the resolve to buy into distress and sell into recovery. This involves acting counter to human nature. For others, a safer route is arbitrage and arbitrage requires illiquidity, or forced patience. Arbitrage and relative value hedge funds require lock ups but are able to us the stability of capital to take advantage of arbitrage opportunities.