

Ten Seconds Into The Future: Investment and Economic Outlook 2012

There is a reason I call this Ten Seconds Into The Future. The chances of getting a forecast right on the economy are probably 50-60% if you're good. The chances of translating that into a call on market direction are probably 45-55% if you're good. So whenever I express an opinion, I'm setting myself up to be wrong. But everyone needs a hobby. So for 2012, here goes.

1. There will be no new crises or nasty surprises, but there are still lots of old ones.
2. The US economy will continue to consolidate its recovery. Unless China derails it.
3. The Chinese economy will continue to slowdown. There is a high chance that it accelerates into a hard landing.
4. Europe is clearly in a recession.
5. India is in a serious funk. Unless it can restart its export economy things can deteriorate even faster.
6. Latin America is likely to recover from its current slowdown on the back of a recovery in certain natural resource markets.
7. Australia is likely to get away with another resource driven recovery.

What are the implications for markets? This is much more difficult to formulate and much more difficult to get right.

- A. US exporters are likely to suffer. US domestics are

likely to prosper. This follows from (2) above. As the S&P500 is replete with companies with external exposure, the broad index is likely to suffer even if individual sectors and stocks prosper.

- B. Asian exporters are likely to prosper. Asian domestics are likely to suffer. This follows from (2) and (3) above. As most large listed companies are exporters Asian stock indices are likely to rise, despite a weaker Asian economy.
- C. European stocks are likely to suffer given their a) there large export exposure, b) the insolvency of their banking system, c) the inability of their political leaders to agree a long term or indeed short term solution for supporting their currency system and banking system. However, the ECB is now in QE(Stealth). QE(S) began 21 Dec 2011 with 489 billion EUR in 3 year repo funding. A second tranche is prepped for 28 Feb 2012.
- D. China's role in the world economy is more important than its relative size. The Chinese economy is growing fast but its not anywhere near the size of the US economy. That said, it plays a unique part in the global scheme of things. The current strength in the US economy originates from a revival in 'exports' and manufacturing. Exports are in parentheses since they are strictly not exports but the production by US companies operating abroad. The most important export markets in the current context are North and Latin America. The most important exports are capital goods. The final link in the chain is North and Latin American exports of resources to China. So (6) and (7) above rely on China growing its economy through a continuation of infrastructure investment.
- E. We see evidence of a slowing Europe ((4) above) in German GDP numbers, so that even Europe's main engine of growth is spluttering. The German economy exports directly to China. A weak German number is a red flag

not on Germany (the signal is too late) but on China. Europe is also weak for other reasons, the main one being a now dysfunctional banking system and money market. No amount of printing by the ECB can solve a fundamental flaw in the Euro system. It can delay the consequences for a significant amount of time but in the end printing money and expanding credit to solve a debt problem is like putting out a fire with gasoline. A loss of confidence is always the root cause of hyperinflation. Until then, expect to see tighter spreads of European sovereigns than you would normally expect when the government is bankrupt. An interesting play on this is to invest via the European banks which will no doubt be parking their cash, apart from with the ECB, in their domestic sovereign's quite worthless IOUs. And for this folly they will earn a spread, accumulate some capital and play a part in a less chaotic disintegration of the Euro if it happens down the road.

- F. (E) above tells us that the Euro must weaken against gold and very likely against the USD even more than it has this past quarter.
- G. (2) above argues for continued USD strength.
- H. (1) above diminishes the probability of another round of US QE. Short rates are stuck at zero as the Fed tries to get some inflation going. The yield curve may start to steepen once Operation Twist is exhausted although it is likely that the banking system may be co-opted to keep it flat. The US still needs low long term rates to get the house owner back to positive equity and positive gearing. Refinancing at current levels of interest rates, if they were achievable, would unlock significant purchasing power for discretionary spending.
- I. Some of the weakness in commodities is due to the dearth of commodity trade finance so there will be a coincident recovery to do with the capital positions of the European banks.
- J. There is an interesting trade in European banks. Spanish

and Italian banks are under a shorting ban because investors would like to short them. The natural trade for such investors is to buy puts. If one is of the contrarian view that the 3 year repo is a de facto bailout recapitalization of the European banks, one must prefer Spanish, Italian and French banks to German banks. The trade therefore involves going short the cash stock of German and creating synthetic long futures in Spanish, Italian and French banks through their options (selling the expensive put and buying the cheap call.)

If all this sounds rather benign or even bullish, then you misunderstand. All the above is relative to a nominal or fiat currency benchmark. In 2012, given that no one in their right mind would lend to either of Europe, the US or Japan, the Bank of England, Bank of Japan, ECB and the Fed will be printing warehouse loads of funny money for the sole purpose of lending it back to their governments'.

I eagerly await each day as it unfolds the continuing story of how too much debt was created in the past few decades and where we are going to hide it next. If you can identify the flow of capital and assets, this could go quite well for you. If you're not even looking, then it is certainly no more than a game of chance.

Good luck. We all need a little bit.