The World Economy In Simple Terms 2H 2011

With any luck, you won’t be hearing from me for the next couple of weeks. So I thought I’d distill some of the themes that I’ve discussed in the past 6 months into terms as simple as possible. For it is when things are simplified that their full import is crystallized.

The US is basically embroiled in a domestic argument about the household finances. One party points at overspending, the other at overtaxing. Both accusations are but duals of each other, evidence of the poor management of the government and economy, testament to a government and people who have for too long simply lived beyond their means. (For details look at nominal GDP less debt, aggregate and per capita, and also look at the same on an inflation adjusted basis. Its quite depressing, showing an economy that has hardly progressed in over a decade.)

You can borrow from you neighbours, you can borrow from your friends, your relatives, loan sharks, other insolvent creditors, but ultimately all borrowing borrows from the future, mostly your own future. For some countries likeGreece, Ireland, Portugal, Italy, Spain, Belgium, the USA, the future is at the door.

For the Greeks, the problem is doubly acute but no more or less complex. They too have simply lived beyond their means and borrowed from their European brethren for a generation or two down the road. Many peoples have lived beyond their means. All the countries whose CDS spreads have surged are simply facing the cold judgment of the market.

The Emerging Markets have so far seemed quite clever and immune. That said, even they have expanded their sovereign balance sheets in an attempt to help stabilize a world which in 2008 seemed to have no future to borrow from.

The future seems especially bleak this last week as the market picked on Greece, on Italy and on European equities in general just as the credit ratings agencies in all their forward looking wisdom downgraded Ireland and prepared to downgrade the USA.

But this will pass. Economies have cycles, so do markets. The evolution of a time series consists of the aggregation of cycles of varying wavelengths from ticks to days to months to years. While the gloom will pass, probably within the next two weeks, this is not the time to be complacent. Risky assets cannot trend up unless either 1) central banks resume a wholesale debasement of fiat currency, or 2) there is a real improvement in economic fundamentals.

The former stores downside for the future. The latter will not occur for some years yet, 5 – 6 at the earliest. Why? The sheer scale of the problem, the track record of the economy even in the boom years leading up to 2007 if properly accounted for, various vested interests, governments which either do not or soon will not have the mandate from the people… to name a few. The political consequences bear some thought. The Weimer Republic fell under the weight of hyperinflation and ushered in an era under the leadership of a democratically elected lunatic.

Printing of money is likely to resume in earnest within the next 6 months. This is over and above the coercion of banks to abet a continuation of debt monetization which apparently was to end in June 2011.

A tangent. Whilst previous sovereign crises have always found ad hoc solutions, not always wise ones, the near systemic scale of the current one is likely, or if not likely, should trigger an interest in an internationally accepted equivalent of the Chapter 11 process. It is certainly sorely needed.

What of the bright spots in the global economy likeChina, India and Brazil? It is reasonable to expect China's economy to truly be in rude health. It is even justified to say that a domestic consumer driven evolution is already well underway. To see this, simply separate out entire low cost manufacturing regions and designate these the 52nd state of the USA. This actually brings balance between China and the USA, except that these poor regions are RMB based and are basically being deliberately underpaid by both American and Coastal Chinese alike.

The implications of Globalization have not been sufficiently developed or have been forgotten. Businesses have become increasingly global making the association between a company and its country of origin or domicile increasingly irrelevant or misleading. Many European companies operate globally some even with decentralized regional decision making centres.

Despite a generally gloomy outlook for global growth, the dispersion in growth rates between developed, developing and frontier markets provides potential opportunities for the globalized business in the hands of enlightened management. Production can often be compartmentalized and sent to where the demand is. Research can be located close to centres of relevant academic excellence. The internet increasingly brings goods and services across borders.

Despite a generally difficult investment environment, the dispersion of returns between companies with differing positions within this globalized context provides the enlightened investor ample opportunity for profit.

These opportunities are the continuing evolution of our global economy. Human ingenuity almost guarantees a recovery at some point in time, at the global level. The winners and losers are another matter. The job of identifying these opportunities is non-trivial and will keep some of us in gainful employment. We hope.

The problems that exist today have a deeper cause. They are rooted in moral hazard and a culture of entitlement. Too many people have lived beyond their means. This has been inculcated by a society that over-protects. The solution requires an admission of the root cause followed by a change in mindset and then a policy of financial education beginning at an early age.

People need to realize that public goods come at a price. We can transfer or share the cost but we cannot make it go away. Military might, law enforcement, basic education, medical care, unemployment insurance, and other public goods and services all have a price which must be paid for. Households who do not understand the basic principles of economics will elect leaders who either themselves do not understand economics or worse, prey on their electorate’s lack of understanding.

The prospects for constructive change are therefore poor, and at best such change will take a long time, at least a generation.

In the shorter term, it is unwise to write off significant rallies in risky assets, or indeed local improvements in economic growth. An example is illustrative. It would be advantageous for the US to default on its debt if it did not have to bear the consequences of that default (in the form of higher borrowing costs for example.) For a JPY or CHF denominated investor, however, the US government has effectively already defaulted on its treasury debt with a recovery of some 60-70%. It may not be long, especially if the USD was to fall further, before the US could produce some basic goods more cheaply than some of their current trading partners. The trade balance could quickly swing into surplus.

The longer term prospects, to reiterate, are poor. The emerging market investors who bought developed world debt will learn that you cannot eat money. They toiled and transferred real wealth in the past two decades to developed economies in return for empty promises written on paper. The developed world will struggle to recover as external investors eschew their debt. Only a captive and or coerced domestic investor will fund their debt. That means more saving and less consuming.

For the astute investor, making sweeping general allocations will be inadequate as this fails to recognize the tapestry of the new globalized world in which we live. Traditional strategies reliant on the accuracy of directional bets are also inefficient on a risk adjusted basis. Delegation to professional alternative investment managers whose mandate is to capture alpha and to filter out beta is a much more secure way of making money. Yet even here the talent scouting is difficult and even long track records are confounded by the new reality. There are no easy answers. The investor must reason for themselves, applying common sense, exercising due care and a healthy skepticism, but most of all studying the causes of phenomena and making up their own minds based on knowledge.

Fortunately, the future is not written and I might be wrong, and we may against the odds embark on an era of growth and prosperity. If I am wrong.