

GLOBAL MARKETS

De-lipsticking the pig

A thought to take on vacation is whether you and your competitive peers will return in September to load up on stocks, commodities and oil or to sell them. I do not know the answer. And having terminated our own long exposure to the rally far too early, my view maybe should be discounted. We remain long things like high-yield debt (Figure 1), agricultural commodities and gold.

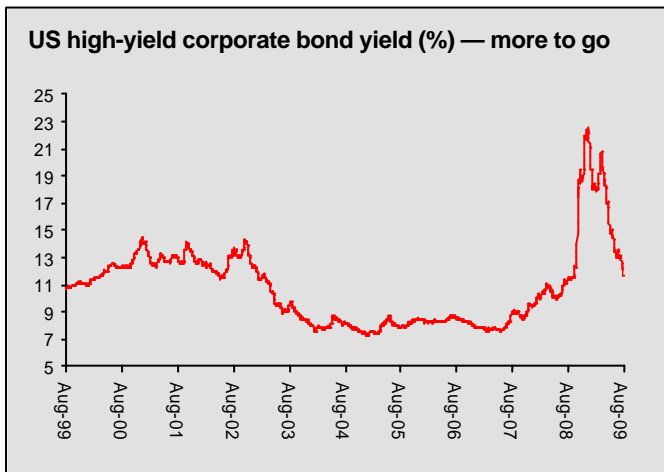


Figure 1. Source: Datastream

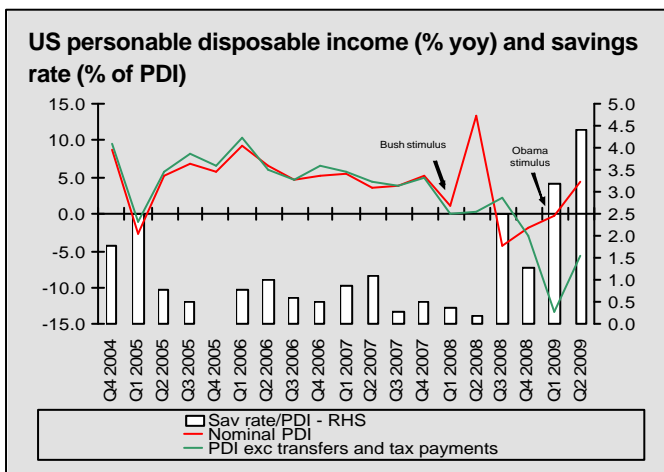


Figure 2. Source: Datastream, Independent Strategy

But I have a view. Let me make the following points.

No V-shape

The US economy has to have a V-shaped recovery for the current valuations of equity, oil and commodity to hold. That will not happen for the following reasons.

First, consumer income will increasingly be determined by wages, not fiscal handouts. Disposable income will fall as the handouts fade (Figure 2).

Despite the manifest profligacy of the US authorities, they cannot repeat their generosity without completely blowing out the fiscal arithmetic and suffering a foreign buyers' strike for US treasuries.

Household savings rates have risen only because government leverage has been transferred to households and used to heft consumer thrift. They will have to rise further and then they will become a net subtraction to consumption. The latest June figures for personal income and consumption showed the biggest fall in income in four years as government handouts fell out of the equation. The savings rate also declined.

5 August 2009

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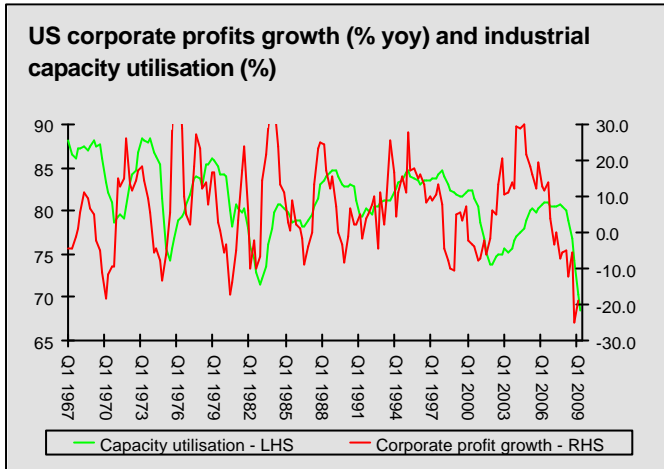


Figure 3. Source: Datastream, Independent Strategy

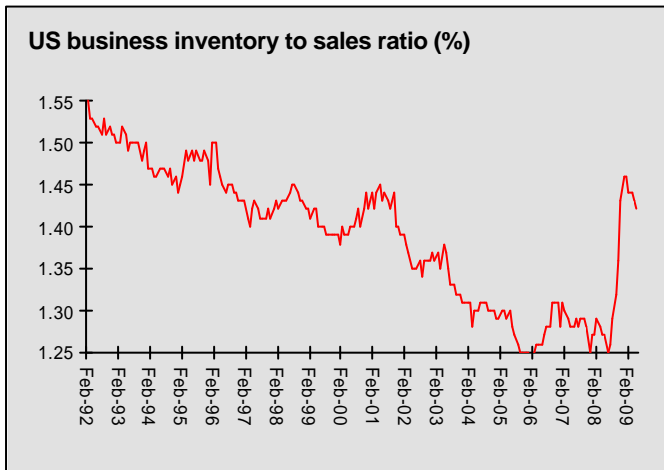


Figure 4. Source: Datastream

Second, there is no need yet for corporations to invest because (despite the market euphoria on Q2'09 earnings), profits are still lousy and spare capacity is through the roof (Figure 3).

Also, the rundown in inventories, to be followed by a restocking (which is supposed to spark an explosion in manufacturing output), will be much less powerful than anticipated because inventory to sales ratios are not lean (Figure 4).

Most important, inventory cycles only spark generalised economic recoveries if they lead to job creation and increased corporate investment. Neither is likely because this is a cycle like no other.

Third, the credit machine is impaired and so is demand for credit. This is not only because there are piles of bad debts still to surface from consumers, commercial real estate and highly-leveraged corporate players.

The other key reason is that the recent improvement in bank financing is down to central bank money (Figure 5). Wholesale debt markets are only dribbling finance into the banks (Figure 6).

Is it really conceivable that the central banks will be able to double or triple their balance sheets to finance a credit-driven consumer recovery while the banks game the central banks to make mega profits? We doubt it.

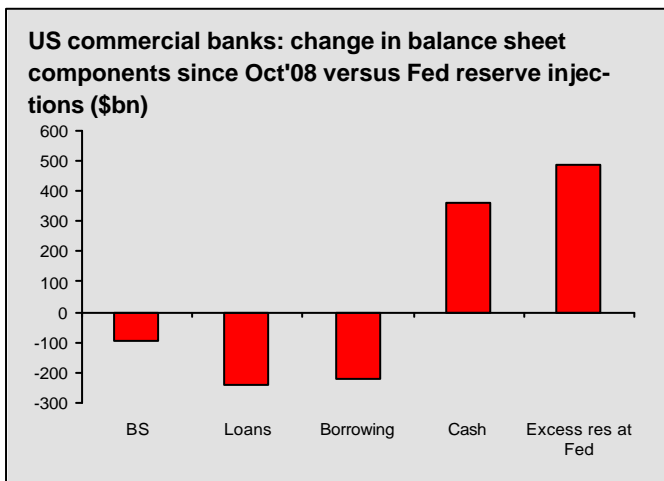


Figure 5. Source: Datastream, Independent Strategy

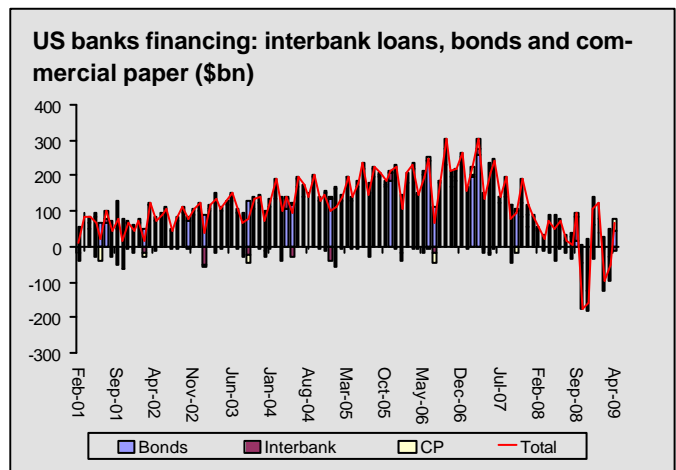


Figure 6. Source: Datastream, Independent Strategy

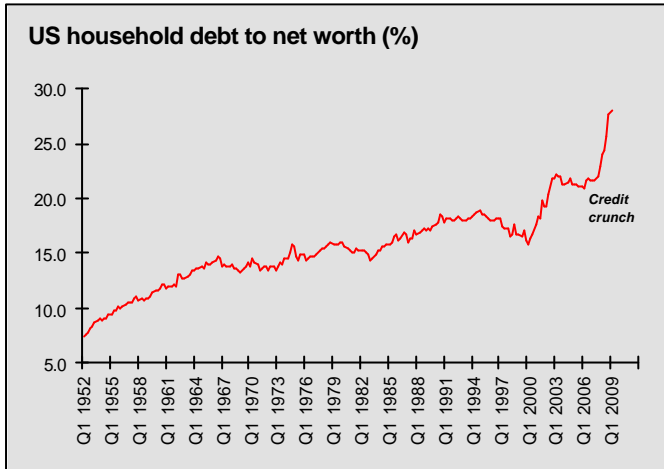


Figure 7. Source: Datastream, Independent Strategy

Fourth, none of the core problems that caused the credit crisis have been addressed. Consumer leverage is worse now than it was then (Figure 7). So is bank leverage.

The leverage party cannot be repeated. The savings-deficit countries (the US, the UK) must see a return to thrift (which will cap consumer spending). One driver of higher household thrift in deficit-ridden countries is that households and corporations realise that the wrecked balance sheets and budgets of the government sector can only be paid for in one way, down the road — with their money.

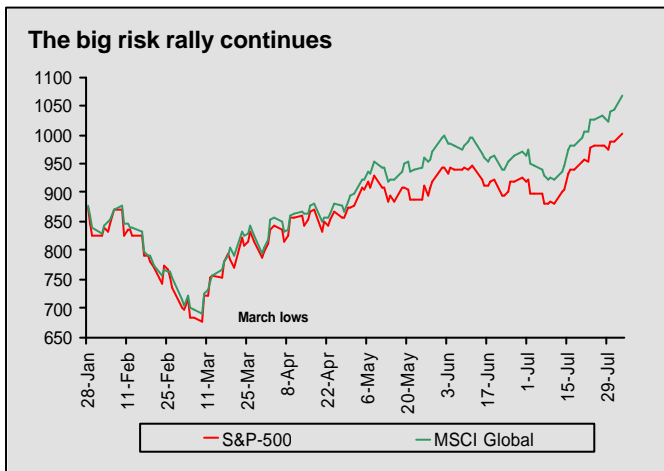


Figure 8. Source: Datastream

The excess savings economies (Japan, China, Europe) are likely to go on being just that (how they invest the savings in the post-dollar standard world is another matter —and that's bearish for the dollar, see our report, *Doomsday for the US dollar*, 27 May 2009). This means slow global growth.

The natural recovery

Of course, this view can be wrong in any manner of ways. And indeed, the equity markets seem to prove it so by making new highs daily (Figure 8). How could it be wrong?

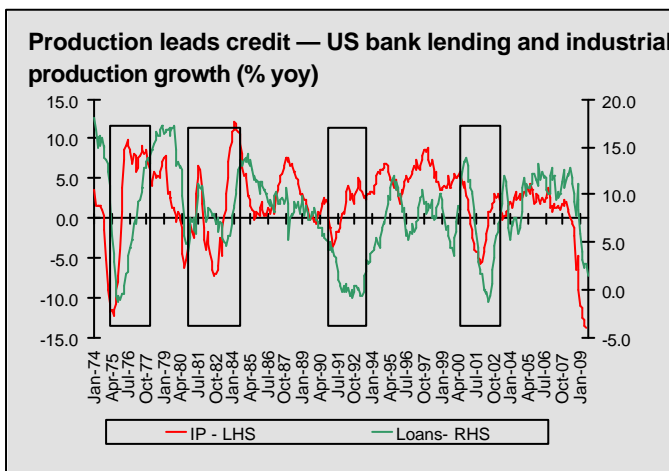


Figure 9. Source: Datastream, Independent Strategy

Credit crises end when the economy starts to grow without credit. Credit only expands later (Figure 9). This can happen because, in a credit contraction, the price of assets and goods and services can fall dramatically.

Near 90% of the people keep their jobs and work income, so the mass of consumer purchasing power only falls by the amount of unemployment and wage decline.

Households lose about 20% of their wealth. But if the price of things (either stuff in the shops or investments) falls by more than the combined contraction of wealth and income, they have become cheaper in terms of the ability of most households to buy them.

Those with money do so. They don't borrow to buy or invest but they have the cash. Those that don't are still busy paying down their debts. But the 'haves' can have enough purchasing power to move the economy off the bottom. This sort of recovery is self-sustaining. Note government has little to do with it!

If we are wrong on markets it will be because we are wrong on the economy. The markets cannot advance or stay where they are unless the economy fulfils their dreams. If we are wrong on the economy it is because the 'natural' recovery described above takes hold.

After much flaying of our collective souls, we do not think this natural recovery will happen. The reasons are that government interference has prevented prices adjusting as they should. This holds for everything from real estate to equities and consumer products (because government continues to finance excess consumer demand — see our report, *The price of denial*, 23 June 2009).

As government solvency worsens, households will also be less willing to spend because they know they will have to bail out the government through higher taxes later. Therefore, the twin springs of the natural recovery are broken.

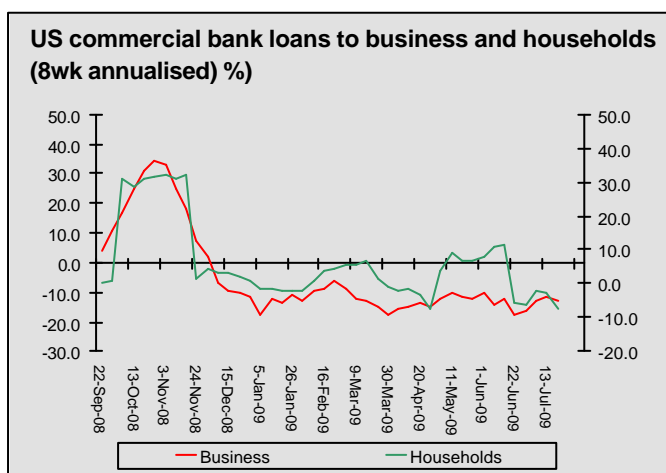


Figure 10. Source: Datastream, Independent Strategy

Liquidity-driven rally

Why are asset markets going up if it so obvious they shouldn't be? It is too facile to say it's all down to central banks printing money because most of that money is being hoarded in banks and not being lent onto corporations or individuals (Figure 10).

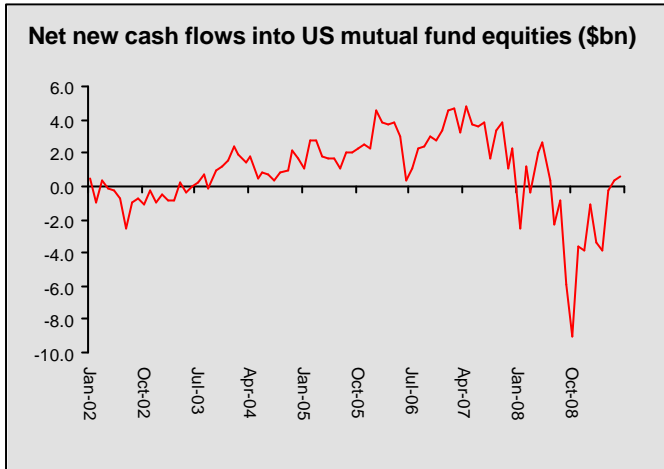


Figure 11. Source: Datastream

The secret lies elsewhere. When central banks operate ‘quantitative easing (QE)’, they buy assets outright from financial institutions to expand the money supply. Individuals are not a part of the process. And the mutual fund and ETF figures tell us they are not part of the rally either (Figure 11).

What happens is that the financial institutions sell their treasuries and asset-backed securities to the central bank and get cash or a deposit in return. The Fed now owns 3% of outstanding stock of US treasuries and 12% of agency (mortgage debt). In sum, that adds up to well over \$1trn (Figure 12).

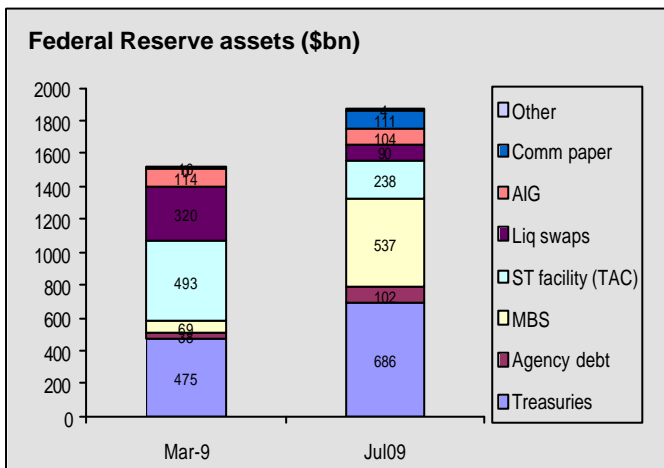


Figure 12. Source: Datastream, Independent Strategy

The financial institutions that previously owned these assets now have cash (Figure 13). They don’t want to hold all this cash because it earns little. So they have been reallocating something of the order of \$400-600bn to equities (and additional amounts to other risk assets).

That is what is driving the rally in these assets. And it tallies more or less with the amount of money needed to move the market the way it has.

Individuals and even hedge funds have played a very minor role. Indeed, individuals have been ploughing their money into bonds and using their cash to pay down debt. One way we could be wrong on markets is if individuals surrender and start buying lots of stocks.

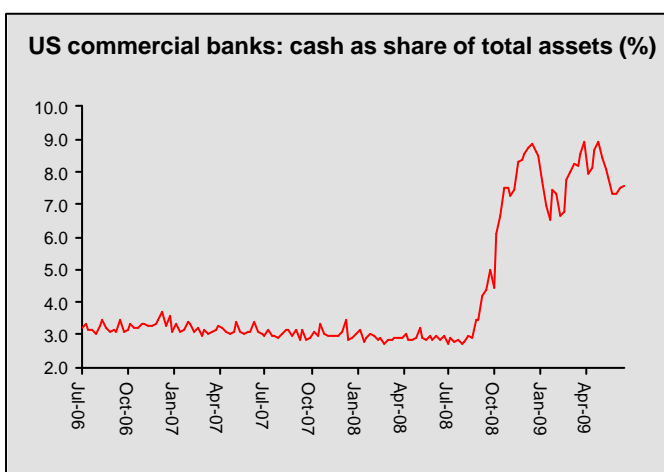


Figure 13. Source: Datastream, Independent Strategy

Of course, the insider game between financial institutions and the central banks can go further. But we do not want to be a part of it because it is unsustainable. It is as finite as QE. Of course, it hurts like hell every day. But so did being a year and half early in predicting the credit crisis.

INDEPENDENT STRATEGY

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