

GLOBAL MARKETS

If!

INVESTMENT CONCLUSION

We are in a world where rational probabilities cannot be attached to feasible macro outcomes. This means much greater volatility in financial asset prices. The ‘Great Moderation’ in the volatility of the real economy and financial asset prices, which lasted for 25 years up to the credit crunch in 2007, is not coming back.

So there are some very big ‘ifs’ for investors to consider. The biggest is that all the ‘ifs’ described below are not just fat tail risks — they are as likely to happen as not. We are now in a world of Knightian probabilities* and the Ellsberg Paradox** when normally-distributed probabilities cannot be rationally attached to outcomes.

An example is the unprecedented printing of money by the Fed. We have never been there. We do not know the outcome. It could create booming global growth. Or inflation and stagnation. Or asset bubbles we don’t yet recognise, which when they burst, cause deflation.

Increased volatility of macro outcomes is the result. Coping with this in investment terms means being prepared to react and not get locked into views and positions that inhibit this. In running a ‘real economy’ business, it encourages a portfolio approach that diversifies the risk of the core business.

ANALYSIS

These are the ‘ifs’ that may happen:

If 1... the US

The US economic recovery has been bought by adding sovereign leverage to private leverage and making both cheap. The former is an act of fiscal policy; the latter of monetary policy.

5 April 2011

***Knightian Uncertainty:** “Uncertainty must be taken in a sense radically distinct from the familiar notion of Risk, from which it has never been properly separated. The essential fact is that ‘risk’ means in some cases a quantity susceptible of measurement, while at other times it is something distinctly not of this character; and there are far-reaching and crucial differences in the bearings of the phenomena depending on which of the two is really present and operating. It will appear that a measurable uncertainty, or ‘risk’ proper, as we shall use the term, is so far different from an unmeasurable one that it is not in effect an uncertainty at all.” — Knight, F.H. (1921) Risk, Uncertainty, and Profit. Boston, MA: Hart, Schaffner & Marx; Houghton Mifflin Company

** **Ellsberg Paradox:** The Ellsberg paradox is based on the difference between two types of risk: one is faced with an urn that contains 30 red balls and 60 balls, which are either all yellow or all black, and one then draws a ball from the urn. This poses both uncertainty — whether the non-red balls are all yellow or all black — and probability — whether the ball is red or non-red.

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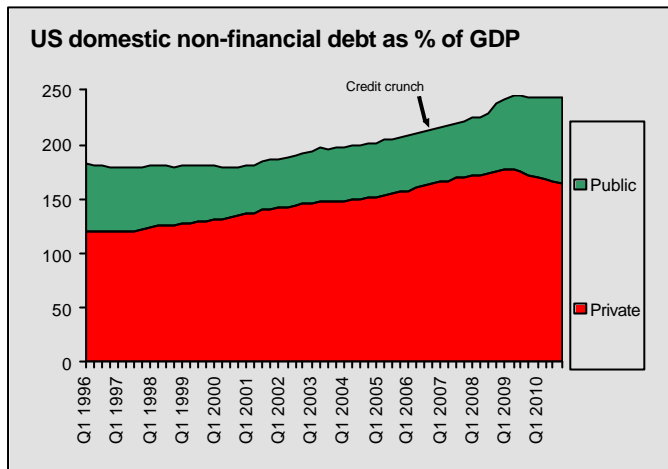


Figure 1. Source: Datastream, Independent Strategy

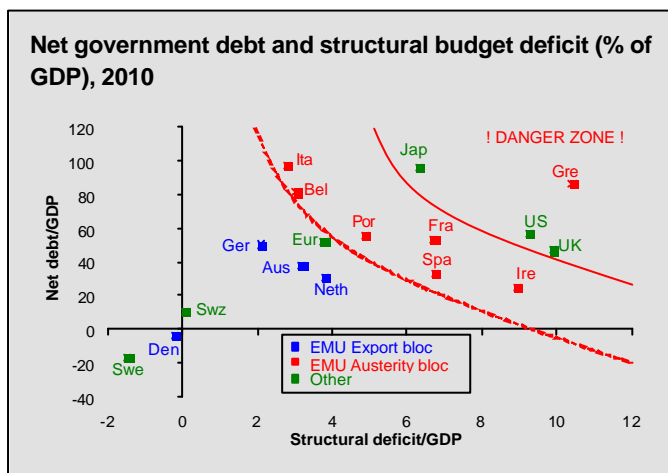


Figure 2. Source: OECD, Independent Strategy

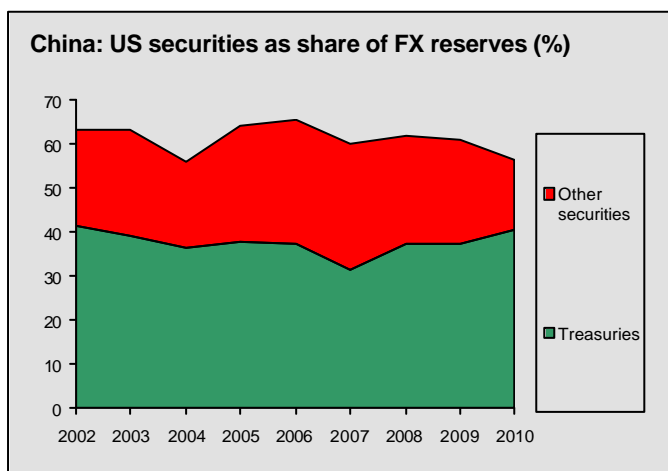


Figure 3. Source: Datastream, Independent Strategy

Today, total non-financial sector debt in the US economy is 258% of GDP. Before the crisis started, it was 230%. Since then households have deleveraged by 4% of their outstanding stock of debt, with 75% of this deleveraging due to mortgage defaults, not thrift. Overall, as a % of GDP, domestic private sector debt is down slightly, while public sector debt has expanded nearly 60% over the same period (Figure 1)!

If all this debt were repriced to the long-term average cost of capital (a nominal 6%) this would transfer a sum equal to 5% of disposable income from spenders to creditors. US domestic demand would collapse. Interest expense on government debt would rise from 8% of expenditure to 13%. This would add at least 2 percentage points of GDP to the existing 9% of GDP budget deficit. Finally, asset prices would fall across the credit space, affecting the cost of capital throughout the economy and globally. As the US now has the fatal debt arithmetic of a Eurozone PIIG, this is merely a matter of time (Figure 2).

When it happens, two other things will too. The Fed will buy government debt and monetise the deficit in unimaginable amounts. The dollar will collapse. Foreign investors will endure a massive value-destruction of their US dollar-denominated assets. They will have no choice.

One reason why China will go on shadowing the dollar with minor renminbi appreciation is to limit the fallout from a potential collapse in the value of its accumulated stock of US assets. It can only diversify out of dollars at the margin. A 30% fall in the dollar against the renminbi would cost a wealth loss of 10% of Chinese GDP.

Indeed, in 2010, China's net purchases of US treasury bonds rose by a record annual amount of \$265bn, to take its holdings over \$1trn for the first time. And as a share of FX reserves, China's treasury holdings reached over 40% in 2010 (Figure 3). However, holdings of other securities (agency and corporate debt

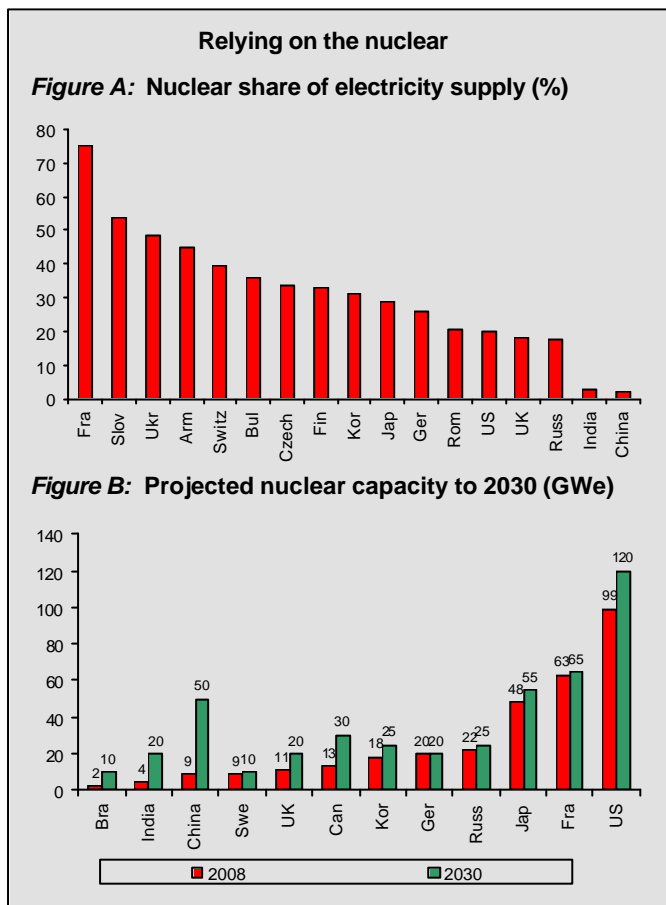


Figure 4. Source: WNA, IAEA

and equities) were cut back, so the share of all US securities in FX reserves fell to a seven-year low.

If 2... Japan

Japan has the worst fiscal arithmetic of any major economy. The long-term fallout from the nuclear disaster could push Japan over the limit because its non-nuclear energy deficit will reduce growth and increase government spending. The economy has few of the natural springs that cause the normal S-curve bounce-back in economies hit by disasters (see our report, *Japan: the aftermath*, 13 March 2011).

However, there is the ‘if’ that the shock to Japan’s system will fracture its existing political structure and produce real leadership. That would be a happy space. One to watch carefully.

The global impact of the Japan’s nuclear disaster may be to stop or reverse the nuclear power/energy contribution in most rich democracies. Places like Brazil, China and India will plough ahead regardless — they intend to increase nuclear capacity by five times in the next 20 years (Figure 4). Nuclearised economies will

gain more relative competitiveness. CO₂ reduction policies will fail. The world will have to pay for climate change mitigation instead and become more disaster-prone. Dependence on volatile regions for oil will increase. Australia will get more terms-of-trade gains as demand for its coal and natural gas increases.

If 3... Europe

Within a short time, the Eurozone crisis will be history. The ECB will ring-fence and separate special long-term resources for bank restructuring from the conduct of monetary policy. The EU will deal with the sovereign debt issues through a mandate covering most of the policies we have listed on what needs to be done (see our reports, *Solving the euro debt crisis*, 30 November 2010 and *Restructuring Europe*, 13 December 2010). The ECB will return monetary policy to normal settings.

The world will then have the biggest imaginable dichotomy in the conduct of monetary policy in various economic blocs. The US will still be in QE mode. BoJ will be set on disaster relief. The Eurozone (and the UK) will

be tightening. Unless the US abandons QE pretty smartly, the dollar will start to decline again. But if QE is dumped, the potential hit to asset prices worldwide is high. Not a good binary outcome, but an investable one. Short EM debt, EM currencies and the greenback!

If 4... asset volatility

The ‘Great Moderation’ spelt falling volatility during 25 years of disinflation. Volatility shrank for economic variables and financial assets. The drivers have been dealt with in many of our reports and presentations (see our report, *New Monetarism*, 26 April 2006). They included disinflation, good monetary management, globalisation, technology and the spread of the internet as well as the freeing of swathes of population to join the world’s free economies.

By the time of the credit crunch, the Great Moderation was dead. The forces that drove it were lessening at the margin (Figure 5). And the

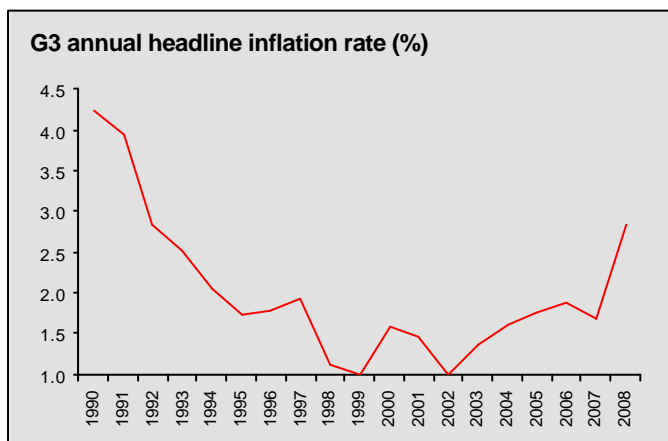


Figure 5. Source: Datastream, Independent Strategy

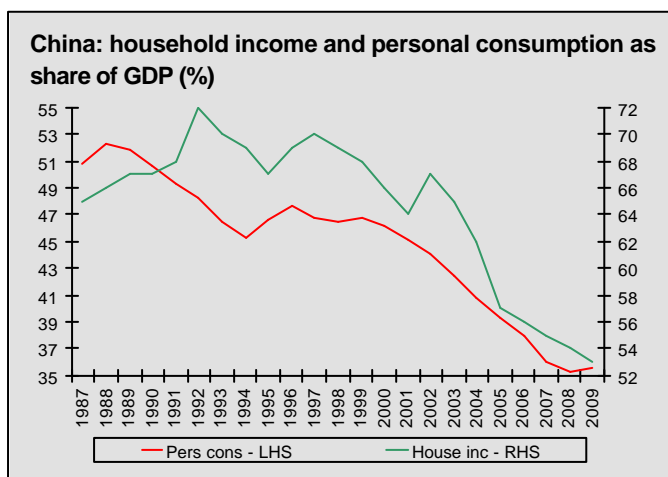


Figure 6. Source: Datastream, Independent Strategy

excess it also caused — over-liberalisation of the financial sector, credit bubbles and lack of thrift — came to dominate its virtues. So greater volatility was our destiny even before policy shifts to deal with the Great Recession magnified the Knightian effects.

Fiscal and monetary policy used to act as dampers of volatility. This was because fiscal and monetary reserves were built up in good times that could act as a cushion in bad. That can’t happen any more. The fiscal and monetary cushions are exhausted. This means we are driving the financial car on increasingly rough roads with no suspension units. The shocks get transmitted directly to the passengers. As they are voters, politics will get more maverick, populist and economically nonsensical.

If 5... China

Things are getting tougher for China. It needs to develop a domestic economy to replace the export and excessive savings /investment model. It is a challenge to grow consumption and household earnings from their much-reduced 35-50% share of national income (Figure 6). The challenge is not just economic. It is social and political. It involves the emergence of a vast middle class. But middle classes make a whole lot of

demands, like the rule of law, clean judges and cops and the end of rule by *diktat*. These are awkward demands for a single-party state where the biggest economic *rentier* is an ex-communist party.

It is no coincidence that all rich countries are democracies*. This is because civic societies, in which open political and economic systems compete, maximise wealth and produce things best. Closed systems do not. Closed systems are where the role of the state is not limited and the freedom of individuals is not guaranteed by law. The ‘Great Liberalisation’ of civic society can free up human economic creativity and allocate resources efficiently to turn it into wealth.

China has only bitten the bullet on a tiny sliver of the spectrum of freedom — that relating to a limited range of economic activity. That worked as long as the challenge was to build factories for export goods, to electrify the Soviet Union or to *chaebolise* Korea. It works for a specific and early stage of economic lift-off. It doesn’t last forever.

* See for example, *A conceptual framework for interpreting recorded human history*, by Douglass North, JJ Wallis, Barry Deingast, NBER working papers 12795, 2007 www.nber.org/papers/12795

It ends when demand and supply get granular. The Soviet *Gosplan* computer could only plan output for one bra. It was white. By the time fashion wanted frills, colours, quarter cups and see-thru, the computer was running three years behind the year it was planning for.

Granularity is the need to produce as many products as defines the personality of those without one in Starbucks. At that point, supply creativity that takes off to satisfy the creative diversity of demand. That creativity is closely bound up with civic freedom. It is the next big EM challenge.

It is a bigger hurdle for China than for Eastern Europe or Latin America. China is a million miles from being an open system, let alone a civic one. It’s still a Confucian system that lends itself to great discipline, thrift, self-reliance and all that. But its stifling sense of hierarchy and the years of rote learning, to which its kids are subjected, are a drag. Creativity comes a lot easier to Brazil or Poland ... or even South Africa.

And China has domestic economic problems of a more than cyclical nature. Monetary and fiscal policies are one and the same thing. What the state wants to spend, the banks have to finance. They have done too much of it of late — all for a worthy tops-down *diktat* to spare China the pain of the West’s bursting credit bubble. But the hidden bad debts of the local authority financing vehicles are not going away and probably constitute 15-20% of bank assets (see our report, *China’s credit bubble — the missing piece in the jigsaw*, 31 March 2010).

The second result of this and the other measures to sustain growth has been to generate massive credit and monetary growth. This has now turned into inflation (Figure 7). Policies have been duly tightened, but with

over-reliance on hefting reserve requirements for banks and administrative measures to stop lending to bubble areas, rather than relying on increasing the cost of money. The price of money is the only effective tool to ration capital efficiently.

The crudity of China's policy instruments makes a smooth economic landing less likely. China's economy will not collapse, but the road will get rougher and the cushions to smooth the passage are smaller. China will get to be more volatile; more like the West.

We have come full circle. What happens to China will characterise all emerging market (EM) financial assets to some degree. This is not priced into EM assets. EM currencies are struggling to go up, not down.

And EM FX bond spreads and CDS premiums are priced to perfection compared to DM bonds (Figure 8).

EM equity markets sell at large price-to-book premia to their DM peers even by historical standards (Figure 9).

All of this is likely to reverse; and not with a whimper, but with a bang.

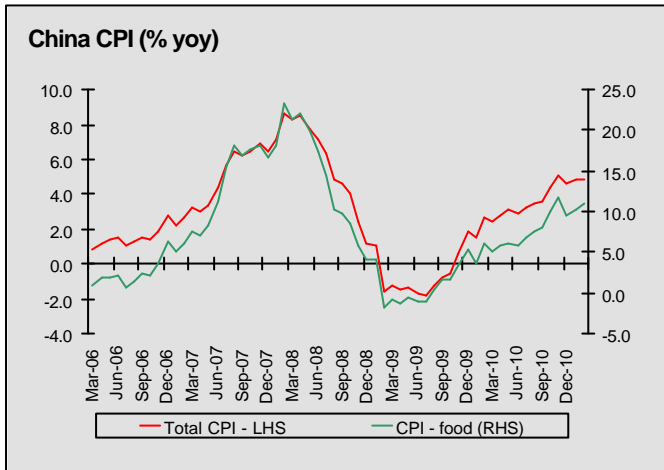


Figure 7. Source: Datastream

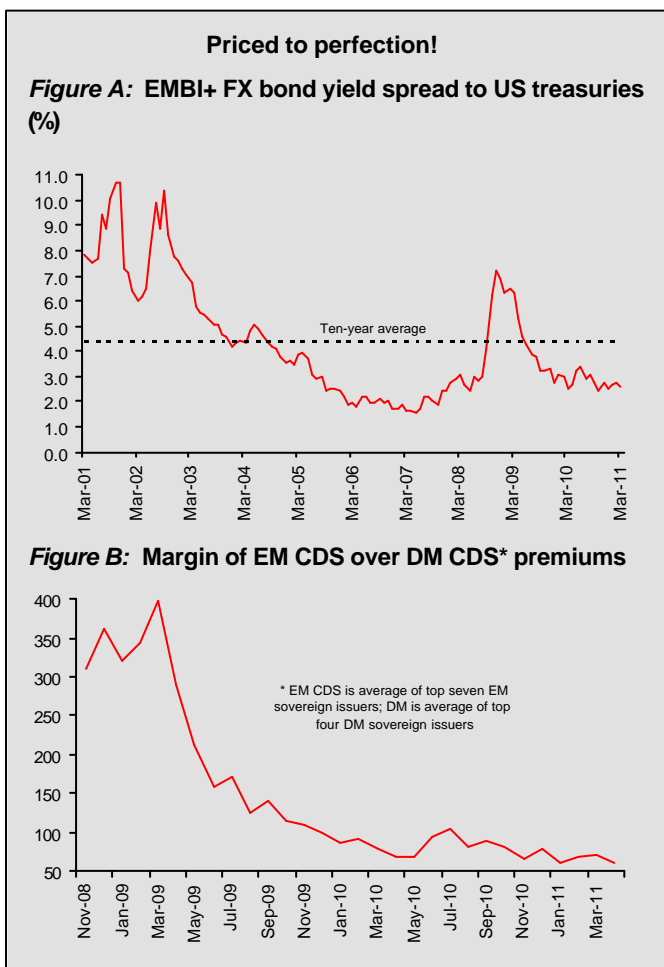


Figure 8. Source: Datastream, Independent Strategy

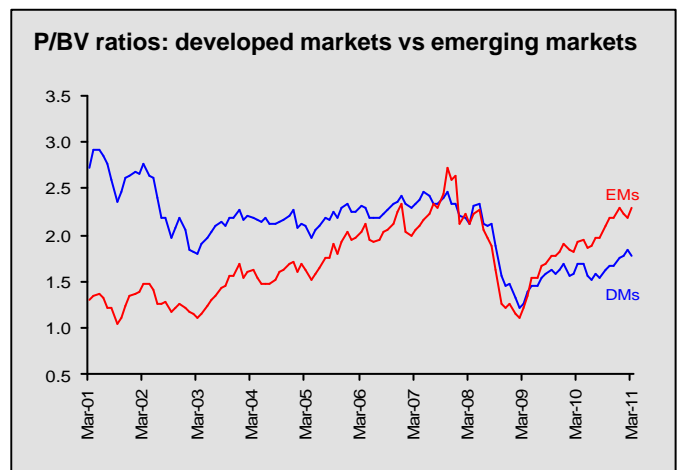


Figure 9. Source: Bloomberg

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