

The Mirage of Recovery

Things never seem to have been so good. The markets are on a roll, the scare of June-July 2010 increasingly looks like a short nightmare, but one that can be forgotten very easily. Data that seems to be emanating out of some of the countries seems to be not too bad (though not good by any measure). The bears seem to have been silenced with the equity markets on a tear. Every body seems to be convinced that we are in a bond bubble. Warren Buffett's recent remarks (that there will be no double dip¹) have only further soothed wrecked nerves. Ironically, the rally of the last two weeks has been largely due to relief that we are not seeing the end of the world scenario. It has been on the back of less bad news rather than genuine good news – a symptom that I would associate with bear market psychology, if not technical bear market².

Is it Time to be optimistic? There probably is no straight answer, as is the case with most matters related to economics. Before delving into a discussion about these things, it may be prudent to look clearly state that trying to forecast the direction of the world economy for the next year has not only become risky but also futile for the simple reason that conventional practices are being abandoned by all the sides at the drop of a hat.

The Mirage of Normalcy:

A good starting point for a perpetual optimist would be to ask the question: what problems the world faced in 2008 have been solved? The short answer: None. What has changed decisively is the fact that we are living in truly momentous times. 'Too-big-to-fail' has become exponentially too large to fail. Government bail outs are now the norm and they go beyond what in the past may have been considered nationally important sectors. This list now includes banks, auto companies, airlines or anybody who is not just too large to fail, but too interconnected to fail. The greater the size of the enterprise, the more assured the survival. Little wonder that there is now yet another maniac race to expand the balance sheet. Cross-border mergers and acquisitions are now the name of the game.

The perpetual optimists (as most of us would like to be) would believe that the conditions are conducive for the inauguration of a new multi-year bull market as on paper and taken out of a historical perspective, the conditions would like very similar to 2002-03. However, a very interesting suggested reading for those perpetual bulls would be read a paper on the website of the St.Louis Fed that is aptly titled *The Monetary base and Bank Lending: You can lead the horse to the water...*³. A number observers who had turned to be remarkably prescient in the past three years have warned of the rising risks of a double dip⁴.

¹ <http://noir.bloomberg.com/apps/news?pid=20601010&sid=ay9Ygiztjg4c>

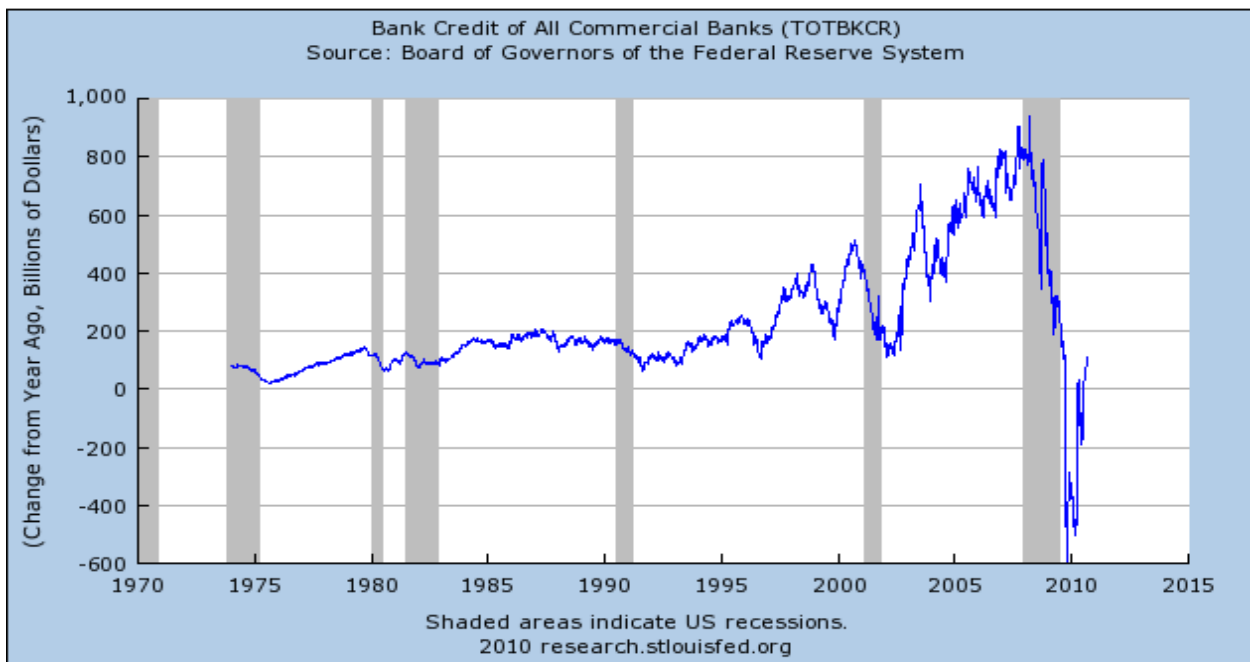
² Technically, we are actually in a bull market and hence this note may not have too much relevance. I say technically we are in a bull market as almost all the national benchmarks (except probably Pakistan) are above their 200 day moving averages.

³ <http://research.stlouisfed.org/publications/es/10/ES1024.pdf>

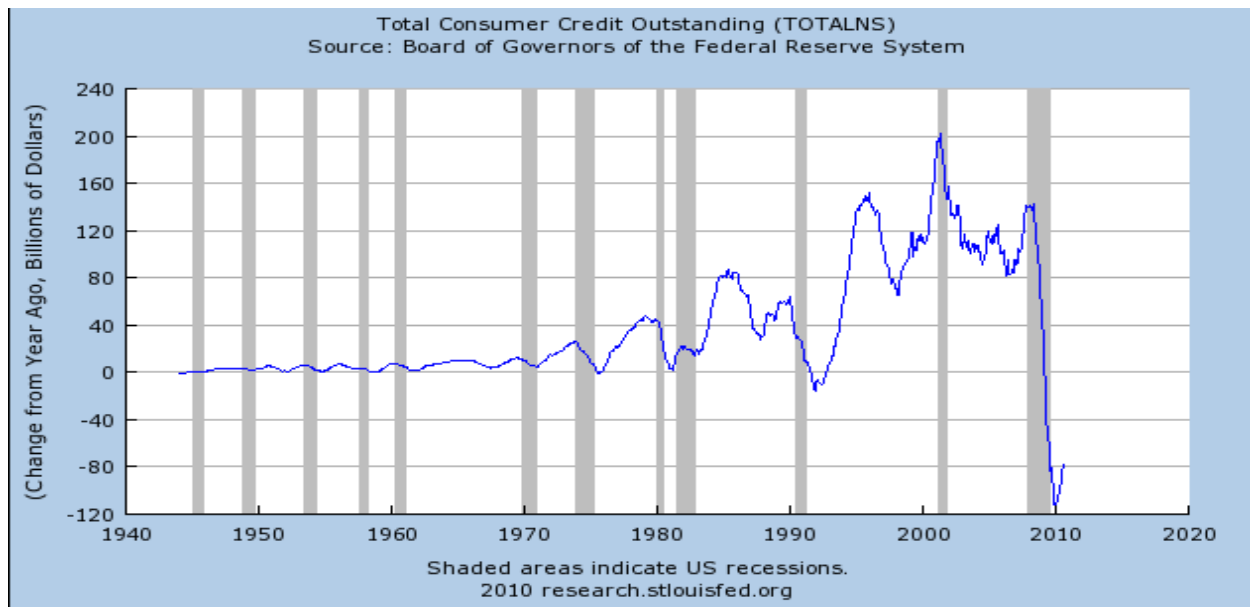
⁴ [http://www.euointelligence.com/index.php?id=581&tx_ttnews\[tt_news\]=2880&tx_ttnews\[backPid\]=901&cHash=94249785ba](http://www.euointelligence.com/index.php?id=581&tx_ttnews[tt_news]=2880&tx_ttnews[backPid]=901&cHash=94249785ba)

The answer to the present recovery mirage lies in the quantitative easing programme of different shades taken up by various governments. The Bank of England pumped in nearly US\$300 billion (and is all set to turn on the spigot), the US Federal Reserve has purchased nearly US\$1.7 trillion of securities purchased by the US Treasury and Federally sponsored housing agencies, European Central Bank continues to accept spurious collateral from the Club-Med countries and lend huge quantities every month. Add to all this a sprinkling of couple of billions by other countries in the form of bail outs and we get a broad idea about the cash sloshing around the world.

Ironically, most of this has not gone into creating real assets in the broader economy, instead it has gone into speculation in the financial markets. The proof: measures of money stock have increased far less than all these money that has come out from the central banks. Monetary base measured by M1 money multiplier has actually fallen. Why? Banks are not too keen to lend. They do claim that they will lend to credit worthy customers. However, in the era of a secular deleveraging cycle, they are a scare commodity. Look no further than the balance sheets of the banks. Their reserves have increased by about US\$1 trillion, but the total lending is lower by about US\$1 trillion from its peak just before the start of the recession (see charts below).



As on 13 Sept 2010



As on 8 September 2010

This note would like to revisit various arguments about the economy. This would be a good time as the economic developments have been more or less on expected lines, though I wish I could have said the same thing about the markets.

First, as always, the good news (or what may be passed off as good news):

- Companies in the US (including banks) have about US\$1.8 trillion cash or equivalents on their balance sheets.
- Tax cuts (at least for the middle classes) would be some form of a unstated stimulus that would provide some respite.
- The markets are on a roll. Since Americans have large investments in the equity markets, a rise would have a positive 'wealth effect' leading to a recovery in the economy.
- Interest rates cannot get any lower and they are bound to stay low for a long period of time. Though how long is a good question, the most likely answer would be many years.
- Policy makers have become proactive and more importantly they are not willing to take any risks that may lead to a relapse in economic growth, unlike in 2008 when they seemed confused and willing to be led by the market events.
- China seems to be avoiding a hard landing.
- It is widely believed that the emerging markets will decouple from the US and western economies and would continue to grow.

Unfortunately, that is where all the 'good' news ends.

What investors may have overlooked?

- What do the bond markets know that the equity markets don't seem to have deciphered. Two months back the US Treasury 10 year yield was at 3.15%, and after nearly three weeks of losses the yields are at 2.85% after touching 2.47%. Interestingly, the interest in bonds have continued despite news that China has reduced its buying interest in US bonds.
- Companies have cash, but a pertinent question that we have to ask is “why are they not investing in Greenfield ventures and are instead buying assets in new lines of business? Is it because they know clearly well that they will not be able to generate current returns in their present businesses?”
- Tax cuts as a hope for stimulus is misplaced. In the present conditions, beneficiaries are more likely to save the money (or repay debt) rather than spend the money.
- China inflation rate actually rose to a two year high. But this was largely due to a rise in food prices.
- Moreover other indications seems to point to the fact that there are no clear signs that overheating has reduced in China, instead indications are that prices (especially the overheated property market), seems to have stopped rising, they are not yet falling. It is only when they start falling will we know the can of worms that it may open. On a month-on-month basis, property prices in China have risen 6% in 70 cities over the previous month (July).
- Rise in food prices may be good for agricultural commodity producers but such a large jump is detrimental to the balance sheet of most of the consumers. This is specially important in the emerging markets where about one-third of a family budget goes into purchasing food.
- Billions of dollars continued to be spent on the broken banking system. However, the major difference being, that the policy makers are not spending hundreds of billions at one go and instead have become cleverer with past experience. They are bailing out banks one at a time and are spacing their bailouts so that it stays below the radar of the lay observer.
- Margin pressure for companies continues unabated.
- Companies still do not seem to have a business strategy in place to meet the onslaught of new regulatory environment. At best they are left to celebrate less stringent new norms that are now falling into place – like the recent rally on Basel III norms.

While each of the above cited may be considered a good news at the present juncture, it may be more prudent for investors to consider all of them to be double-edged swords. The more cautious investors may be better advised to take all these tidbits with at least pinch of salt. The latest data from EPFR seems to indicate that investors continue to withdraw money from equity funds and

are instead parking their money in US bond funds. Emerging market bond funds have been attracting substantial interest⁵.

The trouble spots that existed at the end of the first half of 2010 have hardly vanished. If anything they have actually grown bigger. It is pertinent to note that none of the problems of the world economy have been solved, instead most of the problems have been postponed using doubtful methods that will come back to haunt the regulators sooner rather than later.

Recession or Depression?

While we still have the luxury of arguing over semantics whether we are in the midst of a recovery, recession, great recession or their ilk, to the millions of unemployed or underemployed, it is nothing short of a disaster. Technically we may still be meandering our way through economic jargon of recessions, etc. However, a number of parameters seem to indicate that a deflationary spiral may have already overtaken most of the western countries. A look at the Producer Prices Index released over the past few months seems to indicate that we are living in an era of declining prices and with it purchasing power. Other than food producers and certain commodity producers, it would be difficult to pin point which industry segment has its pricing power remaining intact. While that itself does not mean that we are heading into a deflationary era, other parameters, on which the boom of the past two decades was built on seems to indicate that we are in the midst of a major, albeit slow grinding down move – la Japan. I have continuously highlighted that fear over the past few months and was often met with derision, but unfortunately, my worst case seems to be coming back to haunt us. A good sign of a deflationary spiral that we are living in: the cash on the balance sheet of companies. Ironically, they have been sitting on such cash piles for over a year. Increased savings in countries such as the US is yet another sign of the fact that the deleveraging cycle still has a number of years before we go.

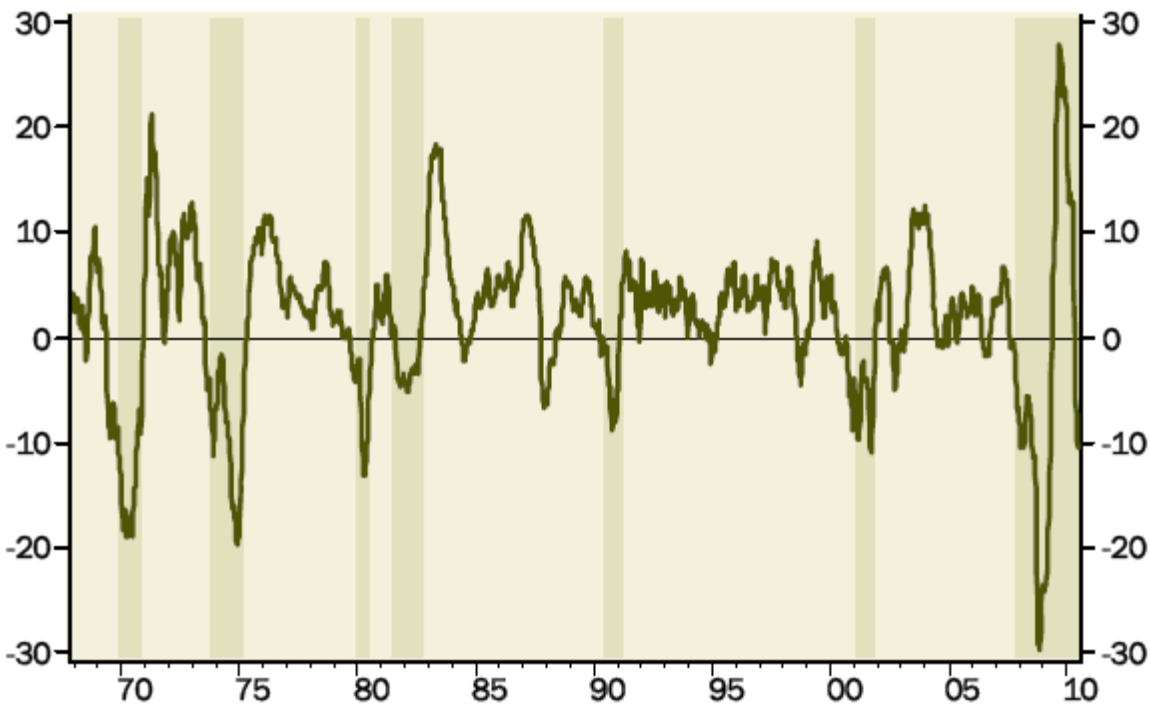
It is important for investors to note that the past few decades of economic growth was essentially based on consumption that was financed by debt, low taxes, low inflation and important government spending (which was again debt driven). This trend of consumption driven economic growth model became central from the late 1980s (in the western countries) and in the mid-to-late 1990s in the Eastern world. The faster we realize that model is broken and beyond redemption, the better. One need not look very far to understand the problems of the US economy. A cursory glance at the US Fed's Beige book indicates that growth is at the weakest point in the past year (the past year has seen weakest growth in years, if not decades). The Fed says that there is widespread deterioration in the past six weeks – only seven of the 12 district banks claimed that economic activity was expanding, down from 10 sometime back.

⁵ <http://noir.bloomberg.com/apps/news?pid=20601214&sid=aPRxN9th86fU>

What are the likely options for the governments? This is probably a tricky situation. Unlike in the past we are unlikely to have a major war rescue the global economy, on the lines of what the Second World War for the simple reason that those countries which can afford to fight a war are all nuclear powers and it is mutually destructive. The other option is for continued stimulus packages, albeit smaller than the last one so that it does not create political problems with the fiscal conservatives, who are growing particularly powerful. The US Fed, as well as all the other central banks would be forced to introduce another round of stimulus within the next 3-5 months. Even the ECB would have to fall in line, though it is likely to be the last and would do so begrudgingly.

A number of indicators that we follow indicate deep signs of stress in the largest economies of the world, especially the US economy. These indicators exclude the bond market, which seems to very clearly indicate that the economy is going to be in trouble for a long time. Some of these indicators are given pointed out below.

(ECRI Weekly Leading Index Growth Rate)



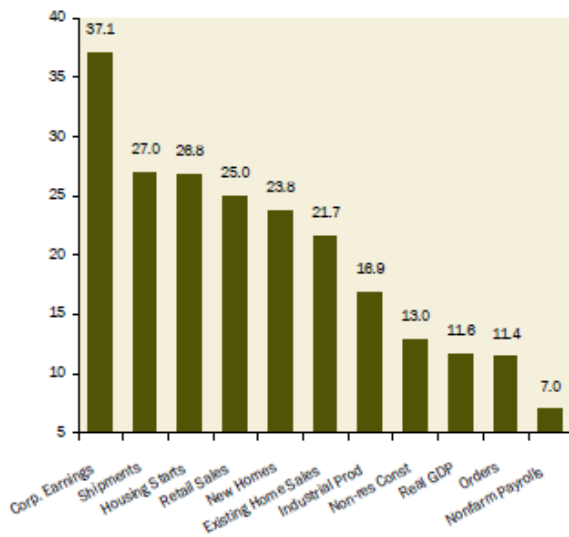
Source: Gluskin Sheff.

How the Present Cycle compares to the past:

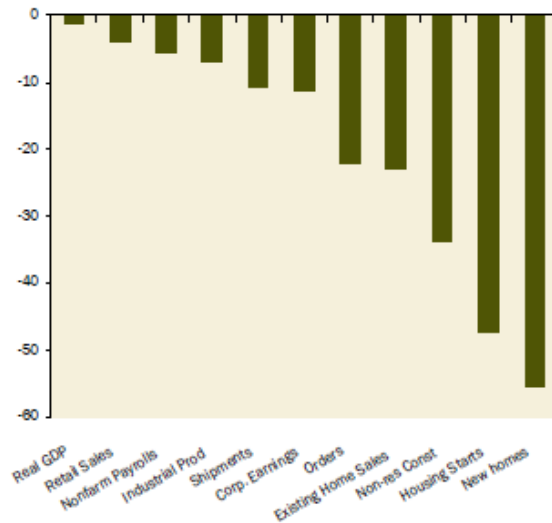
David Rosenberg, who has been consistently highlighting the present pyrrhic recovery, has clearly pointed out the current weakness. The chart below provides a graphical snapshot about how the current economic 'recovery' compares with those in the past. What should make the

current recovery more problematic is that it has been achieved by considerable government support in the form of direct intervention and more importantly by tweaking almost all the important rules and regulations that has helped create the mirage of economic recovery. This is not to claim that there is no improvement in the economy, markets and economies donot move in straight lines. Moreover, the pace of economic collapse in the aftermath of Lehman and the rapid shutting down of the capacities made this bounce possible.

Average, 33 Months After The Start of Recession*



Current Cycle (from the end of 2007)

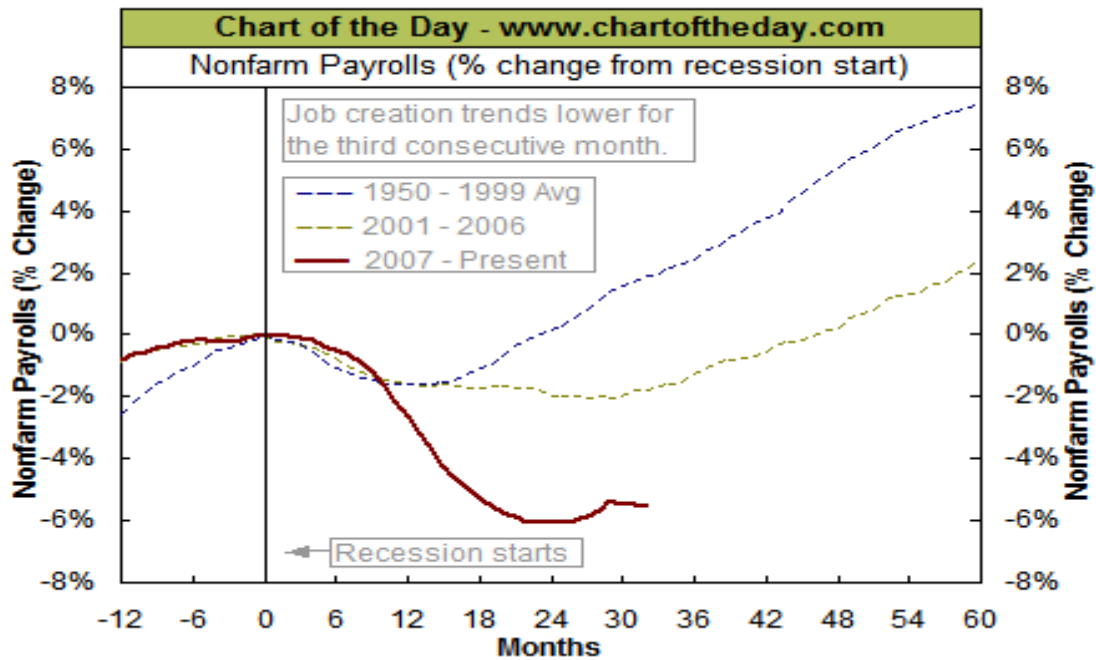


*Covers eight recession cycles going back to 1950 (does not include the truncated 1980 recession)

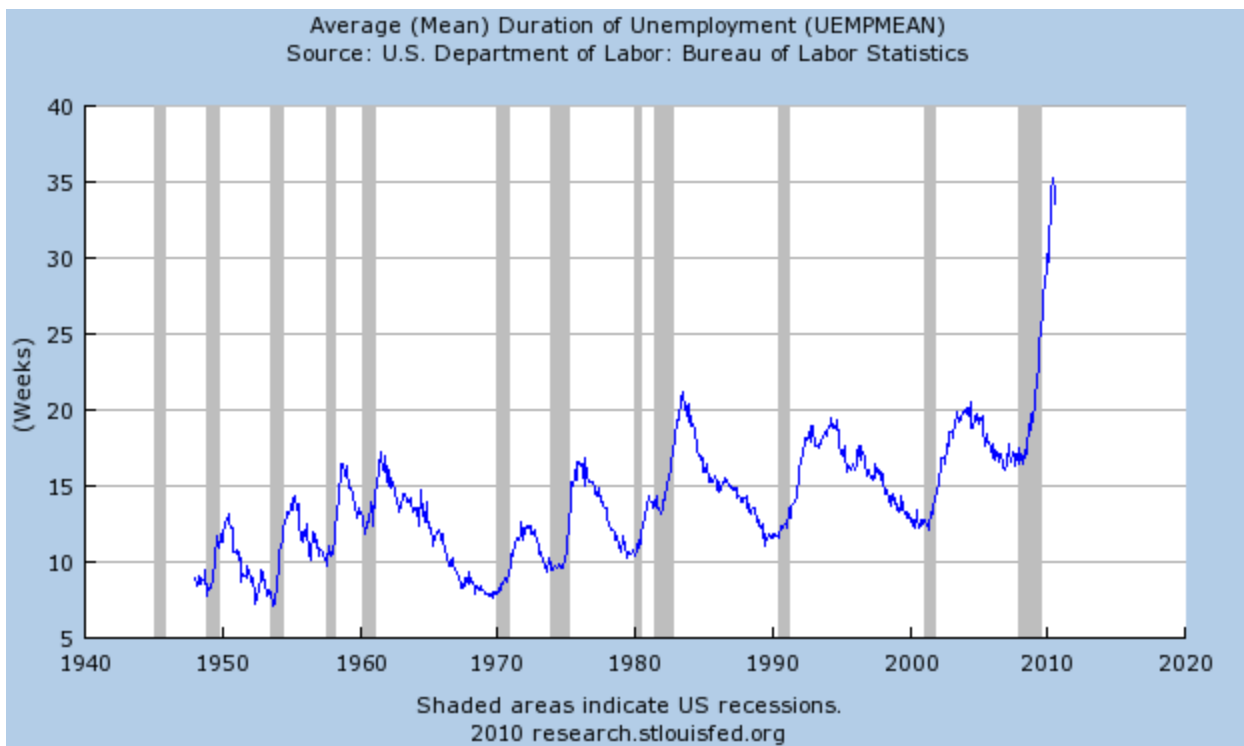
Source: Haver Analytics, Gluskin Sheff

Employment:

Economists have consistently been telling us that employment may not be a primary precondition for the improvement in the markets and the economy. In the recent past they have cited historical precedence. But a cursory glance at the chart above indicates that the current recovery is not only anemic by historical averages, but it is one where employment generation is far from certain. It is likely that we are bound to see a far greater jump in unemployment in the foreseeable future. That all the global stimulus packages have had minimal impact (if at all they have had any impact at all), is clear from the fact that unemployment continues to soar. A recent IMF-ILO report observes that nearly 30 million jobs have been lost sine the crisis – mostly in the rich countries. Global unemployment now stands at 210 million. If the situation is the get any better, the world now needs to create nearly 45 million jobs every year for the next one decade just to maintain a status quo considering that every year new people keep joining the global work force.



Troublingly, half of the unemployed have been out of work for more than six months (see chart below) – the most since the Great Depression. At the same time, wealth disparities have been growing rapidly – a recipe for social disaster in the making.



As on 3 September 2010

By Dr.S.Ananth
20 September 2010

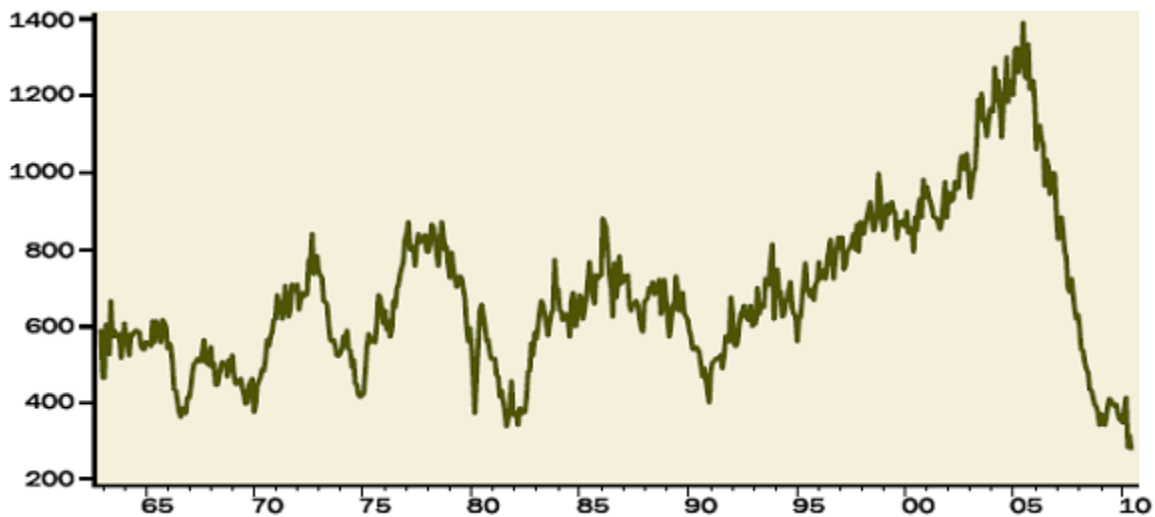
The only reason why USA has not been seeing long lines for food doles (like in the Great Depression) is that the US has been expanding the unemployment benefits. This may not be a recurring feature once the Republicans come to power after the November elections.

Housing: No end in Sight: US Home sales continue to crash

The falling interest rates seem to have done precious little for the housing sector. It was widely expected that the end of government concessions would lead to a decline in the home sales, but however, very few actually believed that the fall would be so precipitous (see Chart below – US home Sales in '000). Source: Glushkin Sheff



The new single family home sales is now at a multi-decade low (see the chart below: Home sales in '000)



Two problems are bound to aggravate the problems of the housing market. Millions of homeowners will have their mortgage rates reset over the next six months. This would not only increase the pressure on balance sheets of individuals, but would also increase the downward pressure on home prices thereby aggravating the virtuous cycle. The second important issue for the housing market is that the banks have started repossessing homes from the customers, after a nearly six months of going slow on the process. Bank repossessions have climbed by nearly 25%. It has been pointed out that nearly 12 million homes are likely to be added to the US housing market due to a combination of new projects and repossession, of this a total of 2 million homes are likely to be seized by lender by the end of 2011, while another 8 million homes that are owned by the banks have not yet reached the market and are expected to do so soon⁶. These figures exclude homes that are likely to be placed in the market by owners desirous of selling.

The housing market is a clear case of the state of the economy, which has been staying afloat largely on government largesse. Stimulus measures till date in sectors such as housing and the auto market have only served to bring forward demand for the future rather than creating fresh demand. This is largely because of the problems that are associated with the debt deleveraging cycle in the western countries. BIS has pointed out that the world has about US\$255 trillion of claims (top 24 countries' banks)⁷. Of that European banks are owed the maximum amount of money. This topic is dealt with in great length in the following section.

Banks:

Popular press seems to have forgotten that the problem started with the banking system. They believe that the world banking system is on the road to recovery. One would like to believe so, at least that is what the market wants to believe. However, the reality is that the banking systems in most parts of the banking system remain solvent only due to the no-so-invisible hand of the governments.

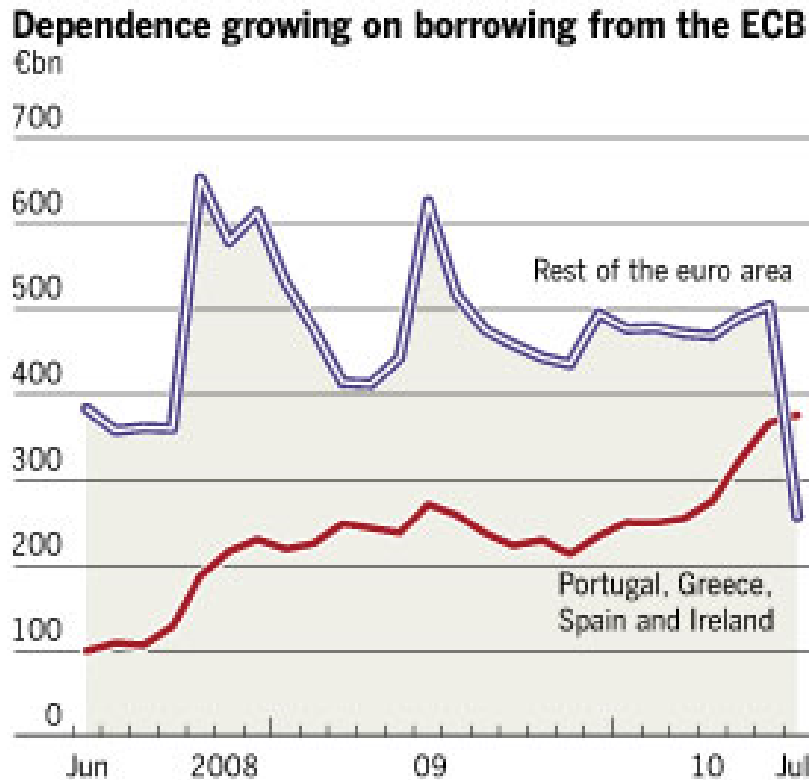
The banks are now facing the consequences that arise because of the downside that would normally accompany a backlash that returns to haunt them after years of lax regulation that has enabled them to mis-sell faulty or overpriced products. Recent news reports about such problems in the case of banks selling home loans on wrong or missing information. It has been pointed out by Compass Point Research that 11 US lenders could incur losses ranging from approximately US\$55 billion to about US\$179 billion⁸.

Banks in the Euro Zone continue to be heavily dependent on the ECB for funding (see chart below).

⁶ <http://noir.bloomberg.com/apps/news?pid=20603037&sid=avzpcRA2QBqU>

⁷ http://www.bis.org/publ/qtrpdf/r_qa1009.pdf#page=88

⁸ <http://noir.bloomberg.com/apps/news?pid=20601010&sid=a6QsDkG2JQcU>



Source: The Financial Times, London

The problem areas continue to remain the same – Ireland, Portugal, Spain, and Greece. This is unlikely to change in the next couple of years. It has been estimated that the cost of the bailout of the banking sector in Ireland may exceed 30% of that country's GDP. None of the countries that have been afflicted by a banking crisis are likely to witness any growth in their economies over the next four to five years. Instead there is a very high likelihood of them battling a deflationary spiral, irrespective of the condition in the global economy. This is clearly discernible in the spreads of the bonds of these countries. Despite the intervention of the ECB in the markets, it is not able to stem the tide of the bond selling. The *Financial Times*, London Reported that last week the ECB was forced to buy about Euros 237 million of bonds, in order to see to it that the spreads did not spiral out of control. The long-term repercussions are clear. Since its intervention began in mid May 2010, the European Central Bank is stated to have bought nearly Euros 61 billion of bonds of Greece, Spain, Portugal and Ireland.

The ECB is buying bonds of Spain, Greece, Portugal and Ireland while selling German bonds. One wonders what would happen to the ECB when it runs out of Bunds and is left with bonds that nobody wants to buy. One pertinent question that long-term investors would have to ask themselves is who are those aggressively selling and exiting the bonds of these countries. This is probably a unannounced bail out of the banks which had in the recent years piled into sovereign bonds of any genre.

At this point, it is imperative that we look at the problem for banks in Europe and other parts of the world. Over the past few years, they have often believed that sovereign debt (of any genre) is a risk free asset and they applied a common yardstick of valuation that was based more on geography rather than economic logic. Little wonder that they

Only when people are confident about growth of an economy are they going to lend. That would be no different for a country. Unfortunately, as countries cut their fiscal deficits, we are likely to witness deterioration in the economic activity and with it the ability of a government to pay its dues due to a fall in revenue that is associated with declining economic activity.

Time to Write off Debt?

One fond hope for many has been that ‘somehow’ consumption in the US and the West would come back. If one were to believe the bond market, it is probably factoring in a situation where this is unlikely. Consumption grows when people not only have jobs but also when people are confident that their way of life will continue remain buoyant in the near future. They tend to borrow more and spend more. Their ability to pay is what makes lenders open their purses. The economic logic is no different for individuals, companies and countries. As various experiments aimed at sparking a recovery have been tried and fail to give us the desirable results, sooner rather than latter, the government’s are bound to reach a situation where they would have to seriously consider either a default or rescheduling of their debt commitments. While this question is considered sacrilege to consider at this point of time, we are bound to reach a time when some form of debt rescheduling/default/write-offs will have to materialise.

The recent BIS Statistical Annex in *BIS Quarterly Review, September 2010* is instructive when it comes to the understanding the magnitude of the problems caused by decades of debt driven consumerism. At the end of March 2010, the total consolidated foreign claims (in other words debt on the books) of banks in 24 countries about US\$255 trillions, European banks account for about US\$184 trillion. The total claims on USA (government and private) nearly US\$52 trillions. Banks in the US account for nearly US\$8.21 trillion while the public sector accounts for about US\$33 trillion and the non-banking private sector accounts for nearly US\$ 23 trillion⁹. American and British companies have been most aggressive borrowers over the past one year. Such exponentially large quantum of debt is unsustainable.

There are only two ways that such a large debt problem can be overcome. It would take years of frugality (during which time the US would slip into a depression, if it comes about) or by a simple default. The first option is a very difficult option that very few would like. The second

⁹ http://www.bis.org/publ/qtrpdf/r_qa1009.pdf#page=88

option is easy (at least in some countries like the USA). A recent *Wall Street Journal* article points out that the actual amount of debt that consumers have actually paid down through belt-tightening is only about US\$22 billion or about 0.08%. That is shockingly low considering that over the last two years (ending June 2010) total value of home-mortgage and consumer credit outstanding has declined by about US\$610 billion (annualised decline of about 2.3%)¹⁰. Interestingly the ratio of household debt to income stood at 119% in the first quarter of 2010, down from a peak of 129% in 2007, but it is still far above its 30 year average of 90%, indicating that these defaults or paying down debt still has a long way to go. The borrowing binge, where possible has not declined in any way. In fact it has been pointed out that in the first nine months of this year companies have issued US\$172 billion¹¹. US companies have till date raised nearly US\$83.4 billion in equity and about US\$786 billion in debt (high yield and investment grade)¹².

The path of least pain for the government to revitalise the economies may be to implement the biggest and ultimate bailout in history of the human race – write off debt on a biblical proportion, say about 30-40% of the outstanding debt to all the consumers. This could actually (though I know it would scandalous to point it out) be a more meaningful that bailing out the banks and other large companies. The upside of this measure would be that it would increase the probability of another couple of years of big consumption binge – just as if nothing had changed. This is not to claim that this form of large debt write offs are going to occur for individual consumers, they are more likely to occur for the governments, banks and other too-big-to fail companies rather consumers, though from a consumption point of view bail out of consumers could be more useful.

Market Indicators and Economy: Nightmare in Graphical Form

A combination of market indicators provides a completely mixed picture – a rather rare phenomenon. Never in recent times, have so many indicators provided such a remarkably mixed picture. Liquidity remains high and we have the emerging markets facing a inflationary spiral while those in the western world face a deflationary spiral. It would therefore be vital to gain a historical insight about how some of the indicator have performed over the past few years.

A look at the Dow Jones chart of the major indices indicate that there is a lot of uncertainty, more ominously, the trend of declining volumes on rallies and vice versa is not a good omen for the equity markets.

¹⁰ http://blogs.wsj.com/economics/2010/09/18/number-of-the-week-defaults-account-for-most-of-pared-down-debt/?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed:+wsj/economics/feed+%28WSJ.com:+Real+Time+Economics+Blog%29

¹¹

http://online.wsj.com/article/SB10001424052748704416904575502181908674958.html?mod=WSJINDIA_hpp_LEFTTopWhatNews

¹² <http://noir.bloomberg.com/apps/news?pid=20601087&sid=aqhWEbFncL0o&pos=7>



Source: Stockcharts

Shanghai Composite



Source: Stockcharts

The above chart of Shanghai composite is particularly interesting. The importance arises from the fact that the index tends to peak far before the Dow Jones reaches its peak. By that count the index has already peaked. It is pertinent to note that the Chinese benchmark has peaked at time even 3-4 months ahead of the US counterpart. If this trend were to continue, then it would that the world is in for a rough ride over the next few months, if not more.

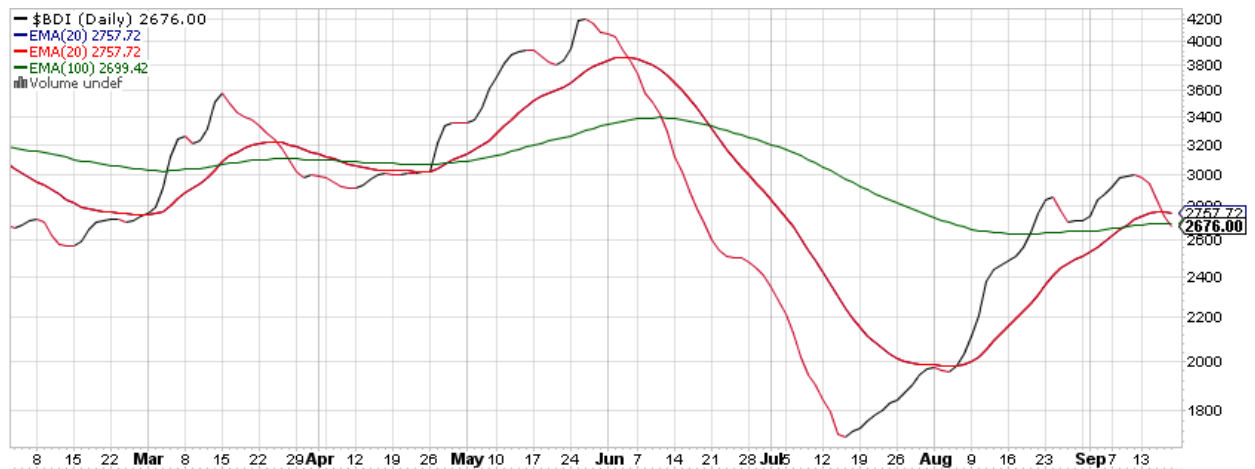
US 10 Year Treasury Price



Source: Stockcharts

The steep fall in the yields of US Treasuries over the past six months has been accompanied by sideways move in the US equity markets, indicating that all may not be well in economy.

The chart of Baltic Dry index (below) is worrisome to say the least. On a pure technical basis, we have the chart closing below the 200 day moving average, there are very clear negative divergences building up on the chart, indicating that it is set for a substantial down draft. Unfortunately, the fundamentals are not too impressive either. A slowing China and the world economy does not indicate any reason for optimism, unless there are sudden black swan events that lead to a huge rise in international trade.



Source: StockCharts.

Journal of Commerce Commodity Smoothed Index:

By Dr.S.Ananth
20 September 2010



Source: Bloomberg

New Castle ships waiting off port for loading coal



Source: Bloomberg

An important chart is cited above, shows that the demand from coal from China has just fallen off a cliff – hopefully for the greater good of the world economy (and the Baltic Dry) it should recover soon, failing which there could be trouble. The above chart is important for the simple reason that we China, Japan and India import most of the Coal from Australia. A sharp drop (5 year low) in demand for coal, indicates that the malaise may run deeper than what many tend to

thing. The above indicator is particular important for the reason that it peaked well in advance of the problems with the financial world in 2007, though its importance receded by end of 2008. Ironically the indicator is far lower than the low it touched in 2009.

Investment Strategy:

- As always stay: Cash is king. Avoid the temptation of borrowing money as it is available at a low cost, unless one is sure that it can be deployed at a substantial profit. The case of Japan shows that when things start going wrong on a structural basis (as we have tried to argue), they can stay bad for a very long time.
- One of the few good pieces of advice Warren Buffet has given is: “Price is what you pay, value is what you get”
- Buy gold on declines (as the present run seems to have) taken the price to over extended levels.
- Watch the bond market, fixed income market is far from being a bubble.
- Avoid emerging markets as most them are either in or close to bubble territory in terms of valuations. However, there continues to remain strong momentum in most of these markets, but that seems to be the result of liquidity rather than fundamentals.
- Exposure to food grains, high dividend paying food stocks and even agricultural land may be good long term bet. This could be specially valid for those investing in food and land in Africa as they would be position to take advantage of building a company with the intention for selling once the food, grain and Africa markets become the next investor fad.