absolute return partners newsletter

may 2004

Not Quite as it Seems

What a difference a month makes. On 1st April, with 10-year U.S. Treasuries yielding 3.88%, compared with € and £ bonds of similar maturities trading at 3.97% and 4.77% respectively, the investment community was not the least bit concerned about inflation. Then, in the U.S., the CPI numbers for March were released, showing that consumer prices had gained considerable momentum with an overall increase of 0.5%. Shortly thereafter, Greenspan presented the Fed's view of the economic outlook to the Joint Economic Committee of the Congress. When he uttered the now famous words: *"…the worrisome trend of disinflation […] has come to an end",* the bond market threw up.

As this Newsletter goes to print (3rd May), 10-year U.S Treasuries yield 4.56% (+0.68% since 1st April), U.K. Gilts 4.95% (+0.18%) and € bonds 4.16% (+0.19%). Meanwhile, many commodities have given back large parts of their gains. The Commodities Research Bureau (CRB) Index stands only 3.4% lower than it did on the 1st April; however, the losses in base metals have been significant.

One of the great puzzles of last year was the simultaneous bull market in commodities and bonds. We have argued for a while that commodity prices and bond yields cannot move in opposite directions for any extended period of time.

The reason is simple. Higher commodity prices invariably lead to rising producer price inflation. Producers of goods can then do one of two things. They can either pass the price increase on to consumers (provided they are willing to accept higher prices) or they can take it on the chin, leading to a squeeze on profits.

This anomaly has lasted for a while and is due to a situation quite unlike anything we have seen before. The phenomenon is called *China*. China accounts for about 4% of worldwide GDP, but they consume a much larger part of global natural resources. Last year, they laid their hands on 8% of all oil produced, 25% of all aluminium, 27% of all steel, 31% of all coal and 40% of all cement[1].

The numbers are staggering. And they certainly help to explain why it has been possible to enjoy a relatively benign interest rate environment at home at the same time as commodity prices running amok.

At this point in time, though, there is increasing evidence that consumers in the United States are beginning to accept price increases again after several years, where producers had to take the knock. And even the most patriotic business manager would be foolish not to charge what the consumer is prepared to pay.

Long standing readers of our newsletter will know that we have been concerned about the situation in China for a while now (see our December 2003 Newsletter). It would certainly be an exaggeration to suggest that the bubble has already burst. But when Chinese PM Wen Jiabao in an interview with Reuters a couple of weeks ago suggested that China must take "very forceful measures" to cool its economy, equity markets throughout Asia sold off instantly.

We do not pretend to be experts on China. But we recognise a bubble when we see one. The problem with the Chinese version, however, is that normal rules do not apply. China is no longer a planned economy but neither is it a proper market economy. Interest rates are not used to control economic activity the way we are used to in the West.

A simple example illustrates the dilemma Chinese policy makers find themselves in. Every year, 20 million people migrate from rural to urban areas of China. 8 million jobs must be created to feed these people. In order to create these jobs, the economy must grow by almost 10% in real terms. If they fail to deliver, social unrest and political instability could be the result.

For these reasons, and many more, we do not believe that normal logic can necessarily be applied. But China has (at least) one enormous challenge facing it, which we can certainly relate to, namely the weakness of its financial system. Chinese government officials are openly admitting that non-performing loans in banks are running at 40% of all loans outstanding - at a time where GDP is growing by 10%.

Meanwhile, Chinese companies, most of which have limited pricing power because they operate at the commodity end of the market, are facing a serious profit squeeze, as commodity prices start to play tricks. God help us (or rather the Chinese) if their economy turns sour.

Let's return to the *'bond versus commodity price'* paradox for a second. We believe that we are in

[1] *Source: Barrons*

between only the first and second innings of a multi-year bull market for commodities, primarily driven by rising living standards in some of the largest emerging markets in the world, including China.

An economic slow-down in China may cause a temporary reversal of this trend, but we believe that underlying demand for commodity goods coming out of Asia will drive prices much higher over the next several years.

Take oil consumption. In Asia, with a population in excess of 3.5 billion people, 20 million barrels of oil are consumed every day. In the United States, with a population of 280 million, 22 million barrels are emptied daily.

Importantly, Asia's demand for oil is rising much faster than anywhere else. It is likely to double every 8 or 10 years from here on. Barring a prolonged economic slowdown, demand from Asia is likely to play havoc with a delicately balanced oil market, contributing to significantly higher oil prices.

The challenge facing global bond investors is that bonds tend to do poorly when commodity prices rise and visa versa. The last time the world enjoyed a secular bull market for commodity prices, it lasted for 35 years (1945-80). When did the secular bull market for bonds begin? As the bull market for commodities came to an end.

One can make a very strong case that the U.S. Fed is already 'behind the curve'. In other words, with inflation at about 2% and rising, and commodity prices going up as well (bar the last few weeks), the Fed should – all other things being equal – already have raised rates to at least 2-2½ %. The Fed is arguing, though, that all other things have not been equal in recent years.

Easy money was required to avoid the risk of deflation, they reasoned. By and large, markets have not disagreed with this view, but we sense that the bond market is starting to lose patience with the Fed's lack of action. Hence the rising yields at the long end of the market.

Following the traditional way of thinking, the following is what ought to happen next. The Fed recognises the need for higher rates at the short end. The futures market has already priced in a high probability of a rate increase of 0.25% in connection with the Fed meeting on 30th June.

Once the Fed sets out on the road of tightening, they will probably not stop until they reach at least a neutral position. This is the point where interest rates no longer act as a fuel to economic growth. According to Taylor's Rule[2], 'neutral' translates to 4% or thereabout in the U.S.

We are *not* suggesting that Fed funds rates will go to 4% immediately after the elections. However, we *are* saying that, if the U.S. recovery continues to unfold in a classical fashion, we can quite easily see U.S. Fed Funds rates approaching 4% before the end of 2005. Provided this estimate is correct, U.S. long rates will probably be on the wrong side of 6% then. This could potentially become a painful experience for all those who have arranged their lives as if interest rates are deemed to stay low forever.

In Europe, assuming we are faced with a typical cyclical recovery, the economy should improve steadily over the next 6-12 months, and rates should go up accordingly. By the end of 2005, the logic goes, short rates in Europe should not be too far behind those of the U.S. Neither should yields on longer dated paper.

In the U.K., the situation is quite different. The Bank of England is already fast approaching a neutral position in an attempt to cool down a buoyant economy (read property market). Rates now stand at 4% (quite possibly higher by the time these lines are read), and expectations are that we will see at least 4.5% before the end of the year. However, the economy continues to do well despite the ongoing tightening.

As far as the U.K. bond market is concerned, there is little reward for buying longer dated Gilts. The yield curve is extremely flat with 4-year Gilts offering virtually the same yield as 30-year Gilts. In fact, the yield curve is so flat that it is almost inverted, which tells you that there is some probability of a recession looming. Add to that the not inconsiderable risk of sterling losing much of its momentum once the interest rate gap narrows, and long-dated U.K. Gilts are relatively unappealing to all investors but those having sterling as their base currency (unless you buy the recession story, of course).

All of this sounds plausible. At this point, though, it is important to remind ourselves that *when everyone thinks the same, nobody is thinking*. So what could prove wrong with our argument?

We buy the U.S. case to a degree. The Fed *is* likely to play catch up for the next year or two, but we are not entirely convinced that the deflation ghost has been put completely to rest. Neither are we comfortable with the current level of household debts, and we believe the Fed shares this concern.

Most importantly, though, we believe that the U.S. economic recovery will lose much of its vigour in the second half of this year. The tax cuts instigated by President Bush provided a tremendous boost to the economy in the second half of last year and will continue to do so through the first half of this year.

[2] Named after Professor John Taylor. According to this rule, the federal funds rate is increased or decreased according to what is happening to both real GDP and inflation. In particular, if real GDP rises 1% above potential GDP the federal funds rate should be raised, relative to the current inflation rate, by 0.5%. If inflation rises by 1% above its target of 2%, then the federal funds rate should be raised by 0.5% relative to the inflation rate. When real GDP is equal to potential GDP and inflation is equal to its target of 2%, then the federal funds rate should remain at about 4 percent, which would imply a real interest rate of 2 percent on average.

Come the second half of 2004, this stimulus will have run its course, and the economy will have to stand on its own legs.

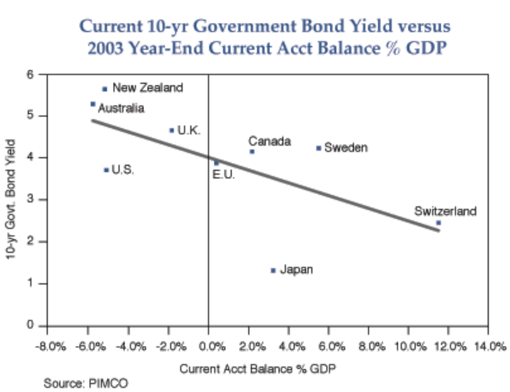
The ability to do so largely depends on job creation. Real wage growth is mildly negative, so no help can be expected from these quarters. We conclude that unless the economy starts to produce at least 2-300,000 new jobs per month, the recovery will most likely run out of steam later this year.

All these factors point towards a U.S. recovery not quite as powerful as one might think at first glance. Meanwhile, in Europe, there are several reasons why the interest rate outlook is more benign than what our superficial analysis above suggested.

Let's start with a recent research piece by Bill Gross, CIO of Pimco (you can find his work at www.pimco.com). Bill argues that the yield gap between the U.S. and Europe is too narrow. He is basing his analysis on two factors, yield-to-GDP and yield-to-current account balance.

As far as yield-to-GDP is concerned, he makes the valid point that, in any country, interest rates should be relatively closely correlated to the nominal growth in GDP. However, with the U.S. economy growing significantly faster than Europe (4-5% versus 1-2%), he makes a convincing argument that you do not get fully compensated by the incremental 0.4% U.S. 10-year Treasuries yield at present.

The second half of Gross' argument goes as follows: countries running current account deficits should be required to pay higher interest rates relative to those running a surplus. He demonstrates that the correlation between interest rates and the current account deficit has been strong for decades. As illustrated by the chart below, he concludes that this approach also supports the notion that the gap between U.S. and European 10-year treasury rates is too narrow.



Another factor supporting our thesis that European interest rates may not rise as much as one would normally expect, given the dynamics of the cyclical recovery unfolding, has to do with our structural view on the economy.

Naturally, any sustained economic upswing in the U.S. will have a positive effect on Europe, but the old continent is struggling with structural problems that, in our opinion, will continue to suppress the performance of its economy. Please allow us to remind you of a table we first brought late last year. It shows the growth rate in real GDP for each of the last four decades in Europe:

10-Year Average GDP Growth (Western Europe Only)

1960-69:	4.9%
1970-79:	3.2%
1980-89:	2.2%
1990-99:	1.9%

The trend is no coincidence, we believe. A combination of falling labour productivity, inflexible capital markets and governments' misguided attempts to protect European businesses has created a longstanding need to restructure and modernise 'Old Europe'.

Combine this with the rapidly aging population in Europe (see elsewhere in this Newsletter), and you are faced with a very unfortunate cocktail. In short, we would be *very* surprised to see Europe roaring ahead the way the U.S. economy has managed to do over the last 6 months. Therefore, European rates will not rise nearly as much as one would normally expect, given the way the U.S. recovery is unfolding.

We would assign at least a one-in-three probability of China hitting a brick wall over the next six to nine months. Should it happen at the same time as the U.S. recovery faltering, there is a distinct possibility of a dramatic world-wide slowdown, possibly even recession, next year. At this stage, we would assign a relatively low probability to this outcome, but it is not as far fetched as you may think.

More likely, China will go through a period of lower growth, causing temporary havoc in Asian stock markets and a substantial correction in commodities prices. Meanwhile, the U.S. recovery turns out to be more subdued than what is on the cards today. In this scenario, interest rates in the U.S. do not go up as much as is widely predicted, and European rates possibly not at all. This we consider a very likely scenario at the moment. Who said the deflation ghost had been buried for good?

The Burden on Our Children

As our regular readers will know, we continue to explore the topic of demographical changes. In this month's issue we will take a look at the magnitude of these changes in the United States, Japan, and Western Europe. But first a little history…

In 1919, statesmen from the United Kingdom, France, Russia, and the United States gathered for *the Council of Four Peace Conference* at Versailles to decide the fate of Germany. Attending the conference was John M. Keynes, then a senior British Treasury official and soon to be the most famous economist of our time. Keynes resigned his position immediately following the conference in protest of the agreement. He argued that the utter humiliation and suppression of Germany was dangerously uneconomical, short-sighted and vindictive in nature.

Subsequently, Keynes wrote his groundbreaking book "*The Economic Consequences of Peace"* in which he presented his views on the role of statesmen. Keynes wrote that a statesman should "…*talk as much folly as the public demand and to practice no more of it than is compatible with what they have said*". Public opinion, said Keynes, is often a spoiled and short-sighted child. Therefore, a political leader should cater to public demand through cheap talk and a few short-sighted, but rather unimportant acts in order to remain in power. However, behind the scenes, a wise statesman should work to serve the best *long-term* interests of society.

One may or may not agree with Keynes's views. However, most of us would probably agree that politicians have certainly been able to "*talk much folly*" in order to cater to short-sighted public demand and as for dishonesty, well… no lack of that in general. The problem is that the dishonesty is often aimed at "four more years" and not the best *long-term* interests of society. The truth is that we are facing extreme demographic challenges over the next 50 years and no one has had the *Keynes-like statesmanship* to attack the problem head on.

People far smarter than us have philosophised over the role of the state in any society. Suffice to say that the size and responsibilities of the state have increased rapidly over the past 200 years. Responsibilities, previously assigned to the individual, are now increasingly assumed by the state with the blessing of the *majority* of the public (yes, we are simplifying). At the heart of the democratic foundation of our society is the notion that 51% of the votes gives you the right to reach into people's lives and pockets (and yes, we continue to simplify). As things stand, we will increasingly reach into the lives and pockets of our children (no simplification here, only the harsh reality).

To reiterate this point, we take a closer look at the concept of generational accounting. Generational accounting is at the core of a brilliant new book by *Laurence J. Kotlikoff* and *Scott Burns* called *The Coming Generational Storm*. For those of our readers with a strong interest in the subject of demographical changes and the global impact of these, this book is well worth a read and has been a source of inspiration and information for this newsletter (and probably a few more to come). The formula for generational accounting is rather straightforward:

    The present value of government purchases
\+ *Official debt*
\+ *Implicit debt*
– *The present value of taxes paid by current generations*
= *THE BURDEN ON FUTURE GENERATIONS*

The equation, in all its simplicity, says that whatever we spend now *and promise* ourselves in the future must be paid for. And if it is not paid for by us, future generations are left with the bill.

The term "*implicit debt"* is the key. Implicit debt is the present value of all benefits we have promised ourselves. This includes pensions, social security etc. In the United States, current official (federal) debt stands at some $4.4 trillion (roughly 40% of GDP or $31,000 per U.S. worker). Large numbers for sure, but not enough for anyone to hit the panic button just yet.

However, add to that the implicit debt of promised social security, Medicare, and other transfer programs, and the combined debt comes to $47.7 trillion! Needless to say, the present value of the taxes paid by the current generations barely covers the present value of government purchases and official debt. The current size of the burden passed on to future generations has therefore been calculated by former U.S. Treasury employees to amount to about $45 trillion (bare in mind that this is the present value of the obligations, not the actual dollar figure required to honour these obligations in the future – these are much larger).

Add to that the latest Medicare drug benefit programme recently approved in Congress, and the number is $51 trillion. Bear in mind though, that the latest federal budget will not contain these numbers anywhere in the report. Before publishing the budget, Secretary O'Neill got the boot and new Secretary Snow *chose* not to include the report. Why? As it turns out, the Bush tax cuts did not exactly help the outlook (talk about speaking folly and acting upon it as well…).

With regard to the tax cuts in the U.S., we may add a note on Reaganomics (lowering taxes to limit government spending, boosting the overall economy and ultimately collecting even more taxes on an absolute basis). Reagan's tax cuts resulted in accelerating GDP growth and lower federal spending as a percentage of GDP. Good news for sure. Unfortunately, the rate of federal debt to GDP rose by 33%, which indicates that tax cuts *did* come at a price.

Worse yet, implicit debt continued its meteoric rise. In other words, Reagan was, as any other politician keen to get re-elected, subject to acting too much upon the folly he inevitably had to speak to get his four more years. And thus continued the tradition of passing on the bill to the next generations. Bottom line, when it comes to Reaganomics, is that it works *but must* be implemented in a tight fiscal regime where the governing powers do not use the perceived benefits before they actually occur. An economy is not a machine that always acts as expected. Banking heavily on future benefits is therefore a dangerous game indeed.

Back to the case in point. In fact, the demographical problem is not a complicated one to comprehend. Over the next generation, 77 million baby boomers will retire in the U.S. alone with all the glorious benefits that they have chosen for themselves, and the first collection of those benefits starts about five years from today.

Consider the following: In 2000, 35 million people in the U.S. were aged 65 or older (almost half of these were 75 or older), while 167 million were aged between 20 and 64. In 2050, 79 million people will be aged 65 or older (56% will be 75 or older) and 224 million will be aged between 20 and 64. In other words, in 2000, there were 4.8 workers for every retiree. In 2050, that number will be 2.8.

Unfortunately, things are no better in Western Europe or Japan. In fact, they are a lot worse. Below is a graphical illustration of the United States, Western Europe, and Japan (source: U.S. Census Bureau).

In 2000, the worker-to-retiree ratio in Western Europe and Japan were 3.7 and 3.6 respectively. In 2050, those numbers will be 1.8 and 1.4. In the U.S., they can, at least in theory, double taxes. This is physically impossible in most Western European countries.

In our opinion, there is no easy fix, which is probably why our political leaders have elected not to spell out the problem in earnest. Importing more immigrants and having people work longer hours will probably help, but it will not fix the problem altogether. It certainly does not help either that politicians continue to speak their glorious folly, making promises for which our children will be held accountable.

In 1919, a thirst for revenge combined with short-sighted global leadership, contributed in large part to the horrors of the late thirties and early fourties. Many men and women, who were not even born in 1919, consequently paid a dear price for decisions in which they had no part. Similarly, future generations are in danger of paying a dear price because political leaders seek to please the majority of people who wish to work less and claim more benefits both now and in old age.

For now, we will leave you with these somewhat depressing thoughts and numbers. In future newsletters, we will look closer at the implications of the aging population, and we promise to add a few silver linings by exploring possible solutions and potential ways to benefit as an investor.