Absolute Return Partners LLP

The Absolute Return Letter
October 2008

The Helicopters are Coming

"We are a nation of morons, led by complete idiots, making us complicit in our own self destruction."

Barry L. Ritholtz

It is time to move on. Not that the crisis is over, by no stretch of the imagination. But it is not going to make one iota of difference if I join the blame game bandwagon. It is what it is. Allow me instead to focus my energy on what is likely to happen next. That is more productive and definitely more useful.

A can of worms

We are dealing with a rather large can of worms. The lid is off and the worms are all over the place. Let's focus on what these worms might be up to. For all the fireworks that the financial sector provides at the moment, at the end of the day, it is the damage done to the real economy that matters to the average household.

Before I go there, I must share a moment with you, of which I am not particularly proud. A couple of weeks ago I had to go into hospital for a minor procedure. As I was lying in the hospital bed waiting to be brought down to the operating theatre, I was chatting with a nurse who asked me what I did for a living. For the first time in my life I was almost embarrassed to admit what I actually do. It is terribly sad that it has come to this. An industry so obsessed with making money that all business acumen and common sense has been brutally swept under the carpet in the name of profit maximisation. I just hope that some lessons have been learned.

Anyway, back to the topic of this month's letter. In the situation we currently find ourselves in, it is very easy to get distracted and lose sight of the bigger picture. All eyes are on Wall Street, obviously with good reason, but there are important dynamics which are being largely ignored. Let's focus on those.

Will $700 billion be enough?

Buying $700 billion worth of toxic mortgage securities from a heavily bleeding banking industry isn't going to make the problem go away. Firstly, $700 billion is not enough to cure the disease and, secondly, mortgages aren't the whole problem. What will happen when consumers stop paying off their credit cards or auto loans? The reckless lending standards of recent years are not isolated to mortgages. It is quite possible that Hank Paulson may have to come back and ask for a second installment.

That doesn't make Paulson's plan a bad first step, though. In the current environment, doing nothing is not an option and all those who have opposed the plan, including the "mental midgets and moral pigmies" in Congress[1], should shut up and work with the Treasurer to move things forward. The United States, and the rest of the world, cannot afford for some narrow minded, re-election focused egotists to take the entire world down.

Europe is skating on thin ice

And neither is the problem unique to the United States. Many European banks have been equally lax, and at least some of these banks are not as well capitalised as their U.S. peers. This week alone, the governments of Ireland and Greece have had to underwrite the entire banking sector, and banking giants such as Dexia, Fortis, Hypo Real and Bradford & Bingley have all been rescued in recent days. So don't kid yourself if you read these lines from your comfy chair in Athens, Barcelona, Copenhagen or Dublin. Europe is getting sucked into this crisis whether it likes it or not.

So is Asia...

And don't even think for one second that Asia can escape the crisis. According to estimates from Simon Hunt Strategic Services, as a percentage of GDP, China's exports have grown from 23% in 2000 to 41% in the first half of 2008. Do you honestly think China, and the rest of Asia can escape a recession in Europe and North America? China's stock market has already smelled a rat and has sold off to the tune of 70% from its high in 2007.

Banks are obviously acutely aware of the high counterparty risk at present and their wariness is best exemplified through the recent explosion in Libor rates – see chart 1 below.

Chart 1: USD Libor Rates

Source: FT.com

It is critical that the inter-bank market doesn't break down completely. If it does, lending will dry up very quickly and the damage to the real economy will be devastating. That's why we cannot afford for Paulson's plan not to go through. Trust in the banking system must be preserved at almost any price.

The recession is coming

Now to the good news. In a couple of years' time, when the dust has settled and (some sort of) normality has returned, I believe that the last week of September 2008 will be remembered as the pinnacle of the financial crisis. We will remember the day (last Monday) when banks

[1] *A quote taken from the title of Woody Brock's latest research paper. I do not need to elaborate on what he thinks of those Congress men opposing the plan.*

in seven different countries had to be bailed out on the same day. We will remember Wall Street suffering its largest points loss ever.

That, however, is not the same as suggesting that the worst of the economic crisis is now behind us. We'd better prepare for a long and painful winter. The U.S. economy is almost certainly in recession already (more about this later); so is the U.K. economy. Continental Europe is probably not quite there yet, although the very latest data suggests that France has now tipped over. It is probably fair to assume that, by the first or second quarter of next year, large parts of Europe should be in recession.

Not as strong as it looks

Many commentators dropped their lower jaw in disbelief when the second quarter GDP report for the U.S. economy was released in mid-September. Some even suggested foul play. Admittedly, all anecdotal evidence pointed towards a weak number, so it is no wonder that almost everyone was a bit surprised to see second quarter U.S. real GDP growth being *revised up* to 3.3%.

So what happened? It may sound strange but there is a simple explanation – the fact that oil prices rose from $101 to $140 per barrel during the quarter. In order to understand how rising oil prices can have such an effect on real (inflation-adjusted) GDP, consider the following equations:

(a) Nominal GDP = Consumption + Investments + Gvt. Spending + Exports – Imports

(b) Real GDP = Nominal GDP / GDP Deflator[2]

Now assume that, in a given quarter, the volume of every component is unchanged. This would obviously mean that *real* GDP would be unchanged. At the same time, assume that import prices rise during the quarter (as was the case in the second quarter). *Nominal* GDP would fall as the value of total imports would rise. As a result, rising import prices lower the GDP deflator which is used to convert nominal GDP into real GDP[3]. Therefore, as the GDP deflator was lowered in Q2, it had the effect of pushing real GDP higher. Bingo!

Prepare for a shock number

My apologies for getting a bit technical there, but I hope I have demonstrated to you that it was neither manipulation nor Mickey Mouse economics which created the surprisingly strong GDP number for the U.S. economy in the second quarter. It was pure and simple accounting techniques which had a bigger than usual impact because of the enormous rise in the oil price during April, May and June. Mind you, almost by magic, the oil price fell back to $100 from $140 during the third quarter of this year. So, when they eventually report third quarter GDP growth, the GDP deflator will be much higher than in the second quarter, and the real GDP number could therefore be shockingly low.

Foreign trade performs well

One of the few highlights in an otherwise rather sick U.S. economy is the performance of foreign trade. As you can see from chart 2a below, if you back out oil imports, foreign trade has performed extremely well over the past couple of years *and continues to do so*. As I have discussed this chart with various different people, I have received virtually the same instinctive response every time – *it is because*

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[2] *The GDP deflator measures the difference between real (inflation-adjusted) GDP and nominal GDP.*

[3] *For a more detailed account of this phenomenon, see http://tvhe.wordpress.com/2008/09/02/the-june-gdp-deflator-in-the-us-conspiracy-theory-edition/*

imports are falling. Not true. Even a quick glance at chart 2b makes it abundantly clear that U.S. exports continue to perform very well. The weak dollar is clearly helping U.S. exporters.

Chart 2a: U.S. Trade Balance

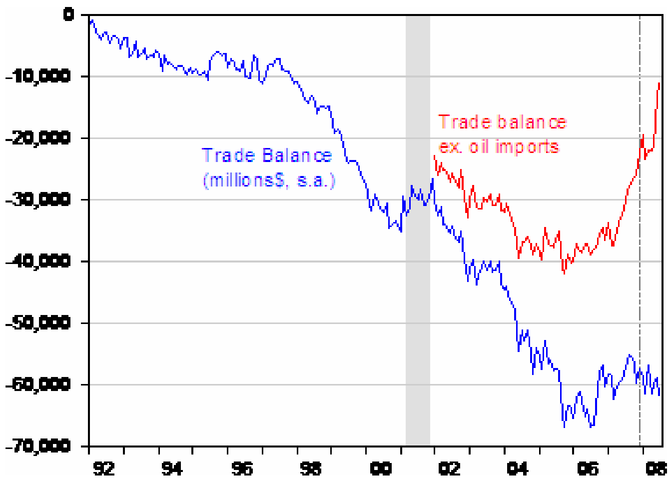
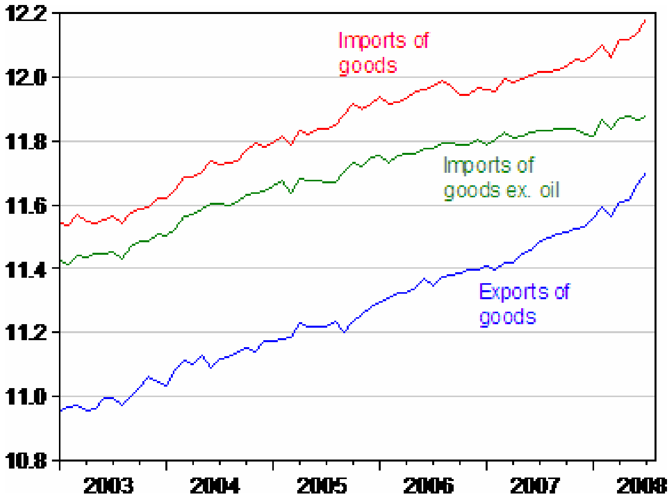


Chart 2b: U.S. Trade Balance



Source: www.econbrowser.com

Obviously, one might argue that it is only a question of time before U.S. exports fall off the cliff. Maybe, but that's not where I am going with this. Much more interesting is the impact this is having on foreign exchange reserves – and therefore on global liquidity - around the world.

Reserves stand at $7 trillion

When the United States runs a massive trade (and current account) deficit, as it has done for a number of years now, it has the effect of boosting U.S. dollar reserves in other countries. No wonder that central banks' foreign exchange reserves have exploded in recent years. When we entered the 21st century less than a decade ago, global foreign exchange reserves stood at about $2,000 billion. Now global reserves exceed $7,000 billion. The reserves are concentrated in Asia with

China, Japan, Russia, Taiwan, India and South Korea accounting for 60% of total reserves between them[4].

But growth has stalled...

Approximately 60% of these reserves are held in U.S. dollars, most of which have been invested in government bonds. The improvement of the U.S. non-oil trade balance has had the effect of slowing the growth of foreign exchange reserves in Asia to almost a standstill. Some countries (e.g. South Korea) have actually experienced a drop in their FX reserves over the past 12 months. A continuation of this trend is bullish for the U.S. dollar but bearish for Asian currencies.

It also explains why global bond markets have done so well in recent years despite evidence of rising inflation problems. About $5 trillion of FX reserves have had to be invested since the turn of the Millennium – much of it in government bonds. Imagine the stimulus such a vast amount of money has provided to bond prices. No wonder inflation worries have been largely ignored by global bond markets!

Don't worry about inflation

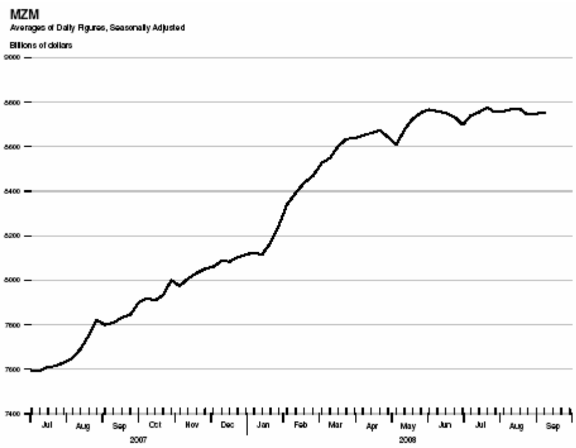
Now, I am going to make a prediction that I may live to regret but the current turmoil in financial markets is about as deflationary as it comes. *Don't worry about inflation!* This crisis will kill inflation more effectively than anyone wants. A year from now, possibly even sooner, deflation will be firmly back on the agenda. Given the massive interventions (read: spending of taxpayers' money) taking place on both sides of the Atlantic at the moment, no government can live with such prospects. Debt + Deflation = Devastation!

And now to the helicopters...

Bernanke's helicopters should therefore take off soon and you should expect dollar notes to be dumped in massive amounts. On this side of the Atlantic, the Bank of England and the European Central Bank are both desperately awaiting a glimmer of good news on the inflation front which will allow them to start cutting rates again. Don't be surprised to see rates over here being cut in half over the next twelve months.

The risks attached to such aggressive monetary easing are limited at this stage. The global economy is facing substantial weakening and money growth has slowed significantly in recent months – just take a look at chart 3 below.

Chart 3: U.S. Money Growth



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4 *Source: http://www.ft.com/cms/s/0/55ba8988-79d0-11dd-bb93-000077b07658,s01=1.html*

Conclusion

For those two reasons, and assuming I am correct about the inflation outlook, it is a low-risk strategy for the Fed, BoE and the ECB to become far more aggressive with their monetary easing. The next few months will define the economic climate for years to come. If the hawks in Frankfurt and London prevail, the outlook is dim to say the least. However, if they step up now, the coming recession may not be particularly deep.

The stock market should react reasonably well to such aggressive monetary easing but, to paraphrase our friends at Cardano[5], if anything, the Lehman bankruptcy has forced equity investors to confront the full scale of the financial crisis, which they have been trying to ignore for some time. And, despite the recent sell-off, there is still little value to be found in equities compared to the deep discounts on offer in the credit markets.

Niels C. Jensen

5 *www.cardano.com*

Absolute Return Partners

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The Structural Alpha Portfolio
as at 31st August 2008: