The Absolute Return Letter
June 2011

Five Misconceptions Squashed

"There's nothing more risky than a widespread belief that there's no risk."
Howard Marks, Oaktree

Last month's letter created precisely the stir I anticipated. You may recall that I came out in defence of human ingenuity and predicted that the oil era will end over the next decade – at least in terms of being the primary fuel for transportation. Not surprisingly, some of my readers scolded me for neglecting the demand side of the equation (i.e. strong growth in demand from emerging markets), whereas others agreed with my conclusions but thought my timing was horribly wrong. Quite a few seem to think that my version of events is a story for the 2030s and not the next decade as I predicted.

Having said that, I had a fair amount of support as well. A number of readers forwarded information about other exciting energy projects in the pipeline, which has only served to reinforce my view that we are at the doorstep of a paradigm shift. In defence of my theory, I suspect many of my critics underestimate the difference between $50 and $100 oil prices. Several of the projects I mentioned in last month's letter make little economic sense at $50. At $100 they suddenly become viable. Were oil prices to go to $200 (not entirely impossible), the development of alternatives to oil would only gain further momentum.

Enough said about that. Let's shift gear to this month's topic, where I challenge some of the most widely accepted investment doctrines. Let's start with a real shocker to get the adrenaline going.

The Fed is printing money: **No it isn't!**

Whenever the Federal Reserve Bank decides to acquire bonds as part of what has become known as quantitative easing (QE), it will execute its purchases through one of the primary dealers, as it must do under U.S. law. Every primary dealer has a so-called reserve account with the Federal Reserve Bank. So, for example, if the Fed acquires $25 billion worth of U.S. government bonds through Citibank, Citi's reserve account will be credited with $25 billion of new reserves in exchange for selling the bonds to the Fed. Such electronic reserves are not akin to 'printing money'. Only if Citibank decides to lend that money to the rest of us, do the reserves flow into the system as real money with inflationary implications.

Should that happen, the Fed has a tool at its disposal introduced only a couple of years ago, and one which is not yet widely recognised. It is called the Remuneration Rate and effectively allows the Fed to pay interest on electronic reserves held by primary dealers and to *change the rate of interest it pays at will* (see here for further details)[1]. The current rate of interest is 0.25% per annum. In our example, should Citibank suddenly develop an unhealthy appetite for lending, the Fed

[1] *Woody Brock kindly educated me about this subtle but important change to U.S. monetary policy*

would immediately raise the Remuneration Rate, thereby making it relatively less attractive to lend.

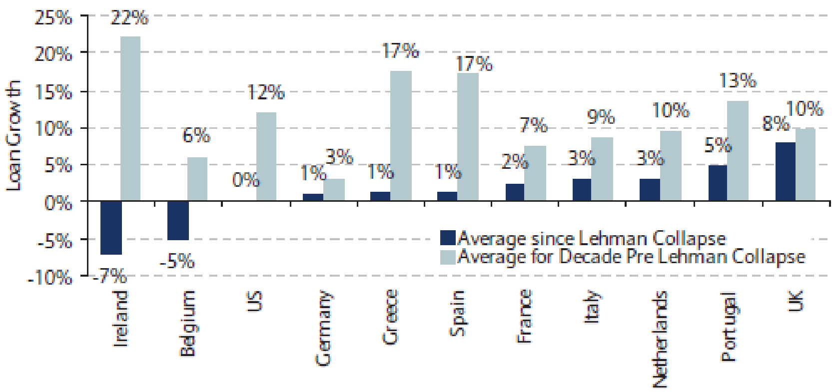
The ramifications of this are tantalising. If the Fed does become worried about the inflationary implications of its QE programme, it does *not* need to reverse the $1.5 trillion balance sheet expansion it has undertaken since the credit crisis. Those securities they have bought may thus be 'retired' for good. It follows from this that the inflationary implications of QE are vastly overstated, at least as far as domestic consumer price inflation is concerned. It also follows that we may not get the big jump in U.S. bond yields that everyone seems to be predicting.

Asian consumer price inflation may be a different story altogether. There is some evidence that Asian consumer prices are suffering the consequences of a monetary policy which is designed to keep Asian currencies broadly in line with the U.S. dollar but which is way too lenient relative to the growth currently enjoyed throughout Asia. Likewise as far as asset prices are concerned. It is pretty obvious that the Fed and other central banks have openly encouraged the carry trade - and thus asset price inflation - over using tax payers' money to re-capitalise the banking system, but that is a story for another day.

Leverage is dead: It is and it isn't!

Talking about state sponsored carry trades, it is not only the banks who have figured out that current monetary policy is conducive to making easy money on risk assets. Hence, when investors talk about leverage being dead, it is only half the truth. As I demonstrated in the March 2011 Absolute Return Letter, loan growth has experienced a rather dramatic slowdown in most countries post Lehman (chart 1) consistent with the perception that the private sector is de-leveraging.

Chart 1: Loan Growth, Pre and Post Lehman Collapse

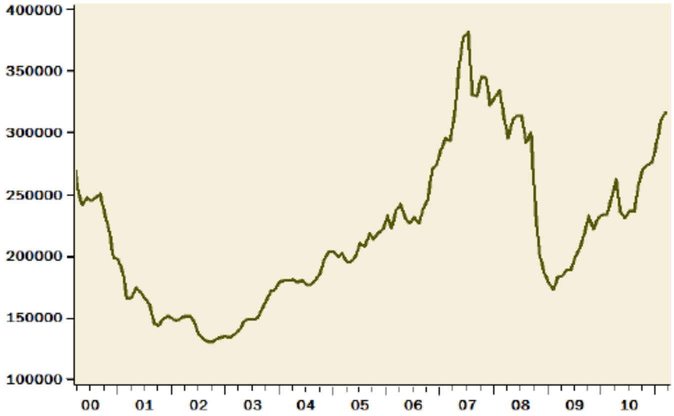


Source: Barclays Capital

However, when I look at the ferocious appetite for leverage for speculative purposes (chart 2), I wonder whether we learned anything at all from the disaster of 2008-09? I find it quite extraordinary that so soon after having been ripped to pieces by the greatest bear market of three generations, investors – or should I say speculators? - happily use leverage again as if there is no tomorrow.

Only twice in recent times have we experienced growth in margin debt of similar proportions. The first time was prior to the dot com bust in 2000-01, and the second time was in the build-up to the credit crisis of 2008-09. We all know how that ended. Rapidly rising use of debt for speculative purposes is a sure sign of froth - even Greenspan would probably admit to that. Debt has the potential to accentuate bear markets, as margin calls force speculators to sell at the worst possible time. Watch this space.

Chart 2: Debt Balances in U.S. Margin Accounts ($ Million)



Source: David Rosenberg, Gluskin Sheff, Haver Analytics

Leverage is also finding its way back into private equity. Howard Marks of Oaktree fame makes this point in his latest letter to investors (see here). And it is not only leverage which is coming back with a vengeance. All the bad habits of 2006-07 are re-appearing in the LBO market: PIK bonds (where the bond issuer can elect to pay interest in debt rather than cash), covenant lite bonds, etc. etc. You name it – it's all there. I suggest you read Howard's letter – makes for some very interesting reading.

Meanwhile, in the hedge fund space, this trend is confirmed. According to one of the leading prime brokers, the average gearing amongst relative value funds on their books is now 5.5 times!

The weak USD is driving oil prices higher: Not at all obvious!

Following QE and the subsequent QE2, many punters have been only too eager to establish causality between the weak US dollar and strong oil prices, and few seem to disagree. Irrespective of the fact that it is highly questionable whether there is such a link in the first place (a point which I will come back to in a moment), it is important to remind ourselves of the fact that correlation doesn't necessarily mean causality.

The correlation between the US dollar and oil prices has indeed been negative in recent years but, at the same time, it is not difficult to find periods where the two have been positively correlated (e.g. 2000-2003). Pretty much all academic research conducted in recent years suggests that to the extent there is causality, it runs from oil prices to exchange rates, not the other way (see for example here). I have found no evidence whatsoever that a weak US dollar drives oil prices higher over time.

In fact, in the long run, the evidence points towards the link between the two being positive, i.e. rising oil prices will drive the US dollar up over time, albeit with a significant time lag. You may find this counter-intuitive. So did I at first. Logic suggests that the United States as an oil importer will see its trade position and its current account deteriorate as a result of higher oil prices, and that is absolutely correct. All other things being equal, the US dollar should therefore weaken, as currencies tend to do when the current account deteriorates.

However, this logic fails to recognise the relative nature of exchange rates. If for example the eurozone is a bigger importer of oil (relatively speaking) than the United States, its current account will deteriorate more and thus sow the seeds for a rise in USD vs. EUR. Obviously, these factors take time to play out, and other dynamics may upset the linkage in the short to medium term, but it is important to keep this in mind.

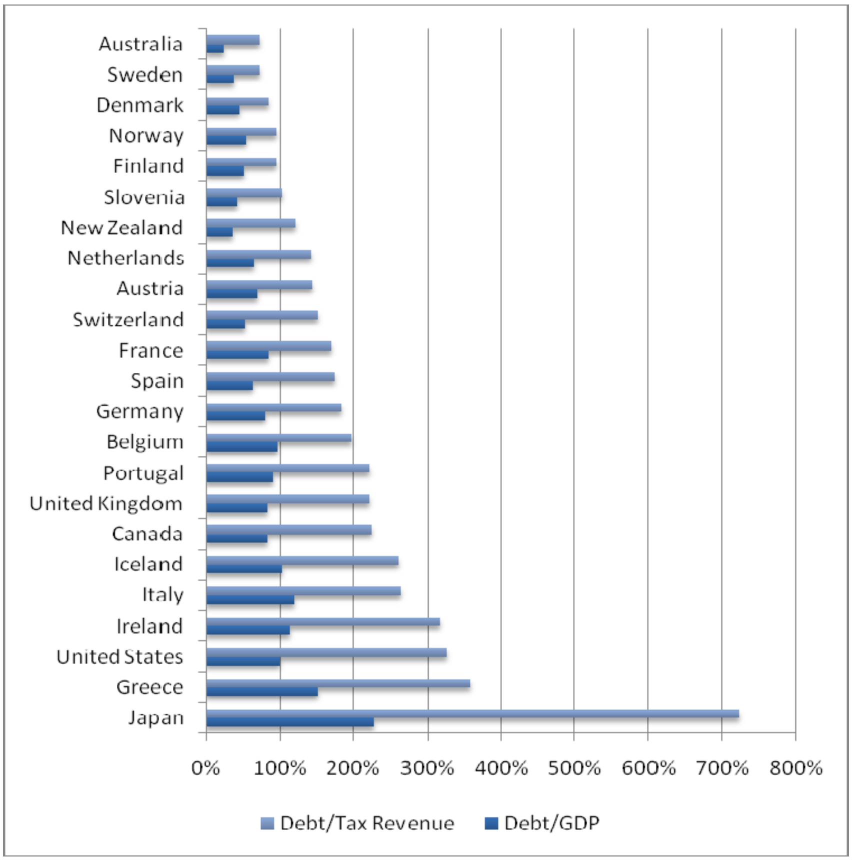
The sovereign debt crisis is a European problem: No, it is a global issue!

Moving on to the problems in Europe, few would disagree that Greece is stuck in the deep end of the cesspit right now. So deep, in fact, that there does not seem a way out for them. But, as we all know, Greece is not alone. Other eurozone members are not far behind in the ugly contest, but that is about as far as investors agree. A small but relatively vocal minority is crying wolf on countries such as the UK, US and Japan, but the vast majority beg to differ. Here is my take on it.

To begin with, in order to fully comprehend the magnitude of the sovereign debt crisis, one has to acknowledge that debt/GDP is a misleading measure of sovereign states' ability to repay their debt. There are several reasons for this. As a starter, the numerator in the equation (the debt component) does *not* pick up all sovereign liabilities. For example, here in the UK, unfunded pension liabilities to civil servants are not included in the official debt numbers. UK debt/GDP would jump by almost 60% if one added those liabilities to the equation.

Secondly, the ratio is a backward looking indicator. We all know that age-related liabilities will grow dramatically in years to come. Such liabilities are completely ignored in the debt/GDP ratio. Thirdly, and most importantly, what really matters are government revenues, not GDP. In the corporate world, in order to measure a company's ability to repay its debt, you monitor debt/revenues and debt/EBITDA. Applying the same logic to sovereign debt, you should focus on debt/tax revenues instead.

Chart 3: Sovereign States' Ability to Repay Debt



Source: Morgan Stanley, IMF 2011 estimates

For all these reasons debt/GDP underestimates the fiscal challenges facing governments around the world. The first to point this out to me was Arnaud Marès of Morgan Stanley, who wrote a brilliant piece last

August called 'Ask Not *Whether* Governments Will Default, but *How*'. He concluded, and I wholeheartedly agree, that it is no longer a question of whether governments will renege on their promises, but rather which ones they choose to renege on and how and when.

If you look at chart 3 above, it is pretty obvious that Greece is in fine company down at the bottom of this rather hideous league table. Now, an argument I often hear in defence of the U.S. position is that tax revenues account for only 31-32% of GDP versus 45% or so in the EU. This implies much more flexibility in the U.S. in terms of taxing its way out of current problems.

This argument is flawed though. U.S. GDP is high relative to household income when compared to the EU and the comparisons are severely skewed as a result. If one instead compares tax revenues *per capita* on a PPP-adjusted basis, it turns out that U.S. citizens pay more in tax than the average Joe Bloggs here in Europe – almost $16,000 per year versus just over $14,000[2]. Anyway, the point I wish to make is that the sovereign debt crisis is one which needs to be taken seriously well beyond the borders of the eurozone.

If Greece goes down, the euro is toast: Not necessarily!

Staying on the subject of sovereign vulnerability, more and more investors seem to share the view that if Greece defaults, it will set off a chain of events which will ultimately lead to the demise of the euro. Even good friend and business partner John Mauldin seems to have jumped on the band wagon, making the following statement in his latest weekly letter:

"The euro appears to me to be a massive short."[3]

I rarely disagree with John but for once I think he is wrong (what are friendships worth if you can't disagree from time to time?). It is all about how and when the crisis is dealt with. Let me explain. For now, the policy in the corridors of Brussels and Frankfurt is that *nobody* will leave the euro. An exit from the euro would – or so goes the theory – cause a devastating run on the banking system. However, few observers have picked up on the fact that the run is already in full bloom in Greece and Ireland. Frank Veneroso pointed this out in a research paper the other day, arguing that Ireland has experienced monetary contraction for several years now[4] (chart 4). If this trend continues, at some point, exiting becomes the logical thing to do.

Another factor often cited is the impact a Greek (or other) sovereign default may have on the European banking system. However, according to a recent study conducted by Goldman Sachs[5], a 60% haircut on Greek government bonds would result in a 52 bps hit to tier 1 capital ratios in Germany and 23 bps in France. Bad news? Yes. Life threatening? No.

Obviously, a 60% haircut would pretty much destroy the Greek banking industry, wiping out about 80% of tier 1 capital according to the Goldman Sachs study. Any restructuring in Greece would therefore have to include a fresh capital injection in to the Greek banks – probably in the order of €30-40 billion. This does, however, seem a much more viable strategy than to keep throwing tens of billions of euros after the Greek Treasury.

For now, though, Brussels and Frankfurt are sticking to their guns. Austerity is the way forward, and all emergency funding so far has been predicated upon a commitment to further belt tightening. However, the relentless pursuit of austerity is a high risk strategy which could backfire spectacularly, politically as well as economically.

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2 *Source: BCA Research*

3 *www.frontlinethoughts.com, 28/05/2011*

4 *Veneroso Associates: "Spain: The domino that is too big to fail", 31/05/2011.*

5 *Goldman Sachs Fixed Income Monthly, May 2011.*

Chart 4: Growth in Irish Monetary Aggregates (YoY % change)

		M2	M3
2009	Dec	- 0.8	- 5.9
2010	Jan	1.7	- 1.2
	Feb	2.3	2.9
	Mar	0.6	- 1.7
	Apr	0.6	- 2.7
	May	- 1.1	- 2.7
	Jun	- 2.0	- 1.7
	Jul	- 1.0	- 1.7
	Aug	- 3.4	- 10.1
	Sep	- 4.4	- 14.9
	Oct	- 3.7	- 19.0
	Nov	- 10.3	- 23.3
2010	Dec	- 9.4	- 19.5
2011	Jan	- 8.6	- 18.4
	Feb	- 10.2	- 20.0
	Mar	- 9.5	- 15.3
	Apr	- 14.3	- 15.1

Source: Veneroso Associates

In Germany, Merkel is not up for re-election until 2013 but, in the meantime, her party is getting crushed in every local election there is. The German electorate is (understandably) tired of funding the mistakes of others. The Bundesbank is now on the hook for more than €325 billion (chart 5) and that number just gets bigger and bigger.

Meanwhile, it is no coincidence that most of the countries in the thick of the current malaise also happen to be the youngest democracies in Europe, and there is a risk (and it is not negligible) that the extreme pain that is now forced upon the citizens of, for example, Greece could invite back the totalitarian regimes which ruled those countries little more than a generation ago.

Economically, austerity slows down economic growth which in turn leads to lower tax revenues. As Reinhart and Rogoff pointed out in their celebrated book “This Time Is Different”, countries default as a result of debt crises primarily because slower economic growth leads to a shortfall in government revenues which are then insufficient to service the debt.

Chart 5: Net Claims between National Central Banks (€bn)

Source: Financial Times

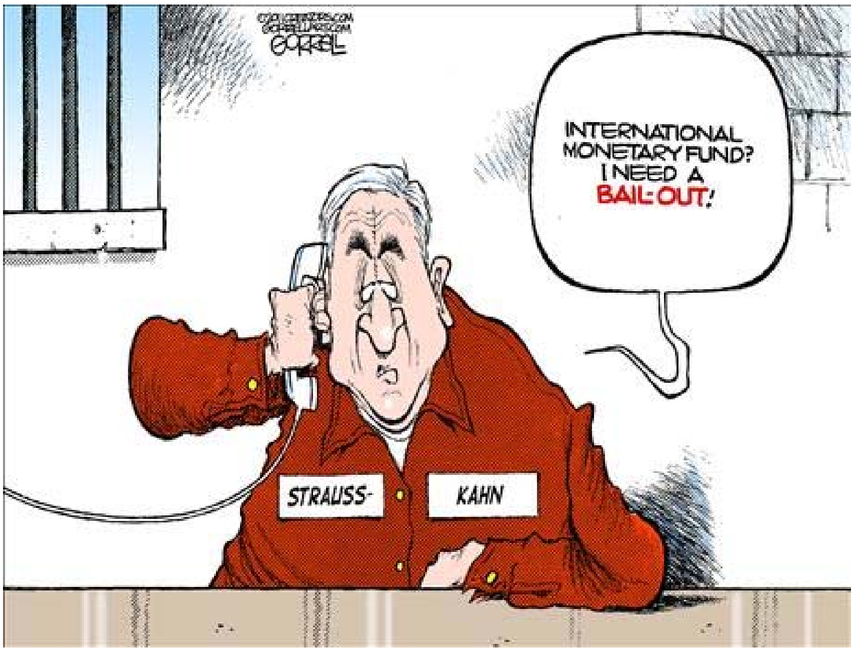
Austerity may be required to get the ship back on an even keel - as in Canada in the 1990s and the UK now - but extreme austerity, which is now expected of Greece, destroys jobs, income and tax revenues to the point where the hole you were already in suddenly becomes so big that you can no longer climb out of it. Precisely for that reason the path currently being pursued is the wrong one. Our political leaders will ultimately realise that and change course. Thankfully (for the rest of us), Greece is still a relatively small country with only a modest impact on the rest of Europe, so the mistakes made are still rectifiable.

For the time being the European leadership seems prepared to 'extend and pretend'; however, the ultimate outcome seems certain to me. The only way forward for Greece is a debt restructuring combined with an exit from the euro. You can save Greece or you can save the euro, but you cannot save them both and, in the end, it is the euro they want to save. The euro bears should remind themselves of the fact that when you remove the weakest link in a chain, what is left is stronger.

Conclusions

DSK is not the only one in need of a bailout! As the sovereign crisis intensifies - and it will - bond yields in some countries will go higher. But they won't go higher everywhere. Demographic as well as technical factors (e.g. Solvency II) will drive ever more money towards bonds, and that money will have to go somewhere. Germany, Switzerland and Scandinavia are probably the safest bets in terms of where sovereign bond yields could fall further. You should also expect high quality corporate bond yields to trade through sovereign yields in many countries. The trend has already begun.

Chart 6: In Need of a Bail-Out?



Source: http://townhall.com/political-cartoons/bobgorrell

Secondly, don't believe the scaremongers. In the blogging community it has become fashionable to predict hyperinflation as a consequence of the current malaise. All level headed research I have seen and done suggests otherwise. Could inflation rise further in the short term? It certainly could but, overall, inflation risk is overstated.

Thirdly, animal spirits are rising, and that ain't good news. I haven't discussed the fundamental economic outlook in this letter, but it is no longer a secret that the global economy is cooling down. In some countries it is even starting to smell like a double dip. This isn't consistent with the growing appetite for risk. Either investors believe the slowdown is transitory or they see QE3 on the horizon. No other explanation can justify current investor behaviour. I believe caution is warranted given the outlook and prefer to take risk off the table rather than to put more on. In terms of which asset classes are most at risk, I would suggest commodities first, equities second. The reason is simple. There is more froth in commodities than in equities at current valuations.

Finally, despite the fact that foreign exchange markets are notoriously difficult to predict, on balance, I come out in favour of a stronger euro against the US dollar over the next couple of years. But it could be a very different looking euro which emerges on the other side of this crisis. Three, maybe four, of the current members could be gone, but there is not a shred of doubt in my mind that the euro will survive in one form or the other.

Niels C. Jensen

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