



The Absolute Return Letter February 2012

The Unlikely Bull Market

Europe is going from crisis to crisis as the rest of the World is doing its best to muddle through. Meanwhile, global equity markets do not seem to care one jot. They only recognise one direction at present and that is higher. Many investors are perplexed. Fundamentals stink, or so most investors seem to think. Some commentators even talk of a pending equity meltdown of cataclysmic proportions. What on earth is going on?

The bears have a point. Fundamentals are not exactly rosy. I have just returned to the UK from a week in Mallorca where I have had the opportunity to take the temperature of Spain through the local media and through speaking to people on the ground. The picture I was presented with was not pretty.

The latest report from Instituto Nacional de Estadística suggests that the overall level of unemployment in Spain now stands at 22.85% (see [here](#)) and youth unemployment has risen to more than 50%. Although a flourishing black economy in Spain ensures that not all these people are without work, the relentless rise in unemployment is crippling the domestic economy.

Hardest hit are retail sales. December sales came in 5.4% below year-ago levels (chart 1), confirming the dramatic loss of purchasing power in Spain. Most other macro indicators confirm this depressing trend, suggesting that GDP should in fact be much weaker than it has turned out to be.

Chart 1: Spanish Retail Sales Continue to Disappoint



Source: Bankinvest

The subject of Spanish GDP has intrigued me for a while (I am a sad case, I know). When I began to do research for this letter back in December, the working title was *Is Spain Cooking Its Books?* Inspired

primarily by Frank Veneroso's excellent work¹, I came to the inevitable conclusion that the economic statistics coming out of Madrid simply did not add up².

Then, on a quiet day between Christmas and New Year when most people had their Bloomburys switched off, the new Spanish government which had come into office only a week earlier, broke the news that the 2011 fiscal deficit would probably reach 8% of GDP - a full 2% over the target agreed with the European Union only a few months earlier (see [here](#)).

Embarrassingly, the admission came only four weeks after the outgoing government had confirmed that Spain was very much on target to keep the deficit below the 6% agreed with the EU. So, yes, Spain was cooking its books and Frank Veneroso was absolutely right in raising the red flag, but I had lost a good headline for the February letter. Back to square one.

The other big issue facing the Spanish economy is the blatantly overvalued property assets on the balance sheets of the banks and savings banks (see [here](#)). From what I heard whilst in Mallorca, the Bank of Spain is becoming steadily more forceful in its handling of the crisis, demanding a far more aggressive approach as to how the banks mark repossessed properties on their books.

To give you an idea as to how bad the situation is, a 2010 profit of about €50 million in Caja de Ahorros del Mediterraneo turned into a loss of €1.7 billion by June 2011 after its property book was marked to market. And that is just one small savings bank (that has since ceased to exist).

The new government has already put out an estimate of how much they expect (read: request) Spanish banks to set aside in additional provisions against bad property loans - €50 billion or approximately 4% of GDP. If that number proves sufficient, the property crisis is probably manageable. It is certainly not of the magnitude seen in Ireland.

On the other hand, consider this: Spain's financial system has about €338 billion of property related assets on its books, €176 of which are classified as bad loans. If Fitch is correct in its analysis that the average foreclosed loan in the Spanish banking system is 43% overvalued (see [here](#)), then Spanish banks should set aside a lot more than €50 billion in provisions. And property prices continue to fall.

Much of the weakness in Spain, and elsewhere, is blamed on austerity but the facts simply do not support this argument. Most of the countries supposedly in the midst of an austerity drive – including the UK whose government has managed to convince the rest of the world that it is doing all the right things but the facts suggest otherwise – continue to run *massive* fiscal deficits. Something else must be at work.

In a credit-based economy, which would include pretty much every country currently finding itself in a crisis of sorts, aggregate private sector demand is not only a function of income but also of changes in debt. Proponents of this idea include economists such as Richard Koo and Steve Keen but, despite the logic of their message, it is a concept ignored by many economists. As Steve Keen writes:

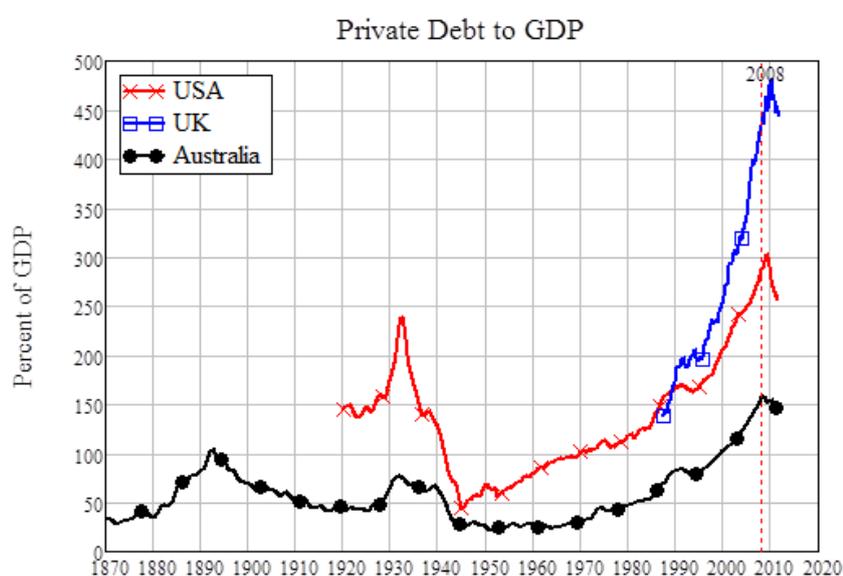
¹ See for example 'Spain the domino that is too big to fall; the economy is falling, the data is lying', Veneroso Associates, 5 December 2011

² If Spain is cooking its books, it is not the first, and neither will it be the last, country to do so. Back in December, the Japanese government announced that it has decided to include interest rate spreads earned by financial institutions when calculating GDP. The changed methodology will add 1-2% to Japan's GDP (see [here](#) for details). Quite miraculously, Japan will – for a while at least – appear to be firmly back on a growth track. Only the most naive would not expect other countries to use similar tactics to give their national accounts a 'face lift'.

“Bizarre as it may sound, these arguments by leading economists ignore decades of empirical research into and practical knowledge on banking, which have established that their fundamental premise is false: a new debt is not a transfer from one bank customer’s account to another’s—which is effectively what Krugman models and Bernanke assumes above — but a simultaneous creation of both a deposit and a debt by the bank. A bank loan thus gives a borrower additional spending power without forcing savers to reduce their spending power to compensate.”³

In a highly leveraged economy such as the UK, even modest changes in household leverage can have a profound impact on the economy as the debt reduction absorbs capital otherwise ear-marked for consumption. Chart 2 below illustrates precisely how much private debt has escalated in the UK in recent years and how much de-leveraging is still to come, assuming we need to return to debt levels last seen in the 1980s before the explosion in private debt.

Chart2: The De-leveraging Process Has Only Just Begun



www.debtdeflation.com/blogs

Source: Steve Keen’s Debtwatch

Given those dynamics, and given the bleak prospects of a sustained upswing any time soon in Europe, there are commentators who argue that the ECB should engage in quantitative easing similar to the policy pursued by the Federal Reserve Bank and the Bank of England. To those people I say: *Wake up. Where have you been for the past six months?* The ECB together with the national central banks of the eurozone have engaged in massive QE since last August (chart 3) although they have done their best to be quite discreet about it.

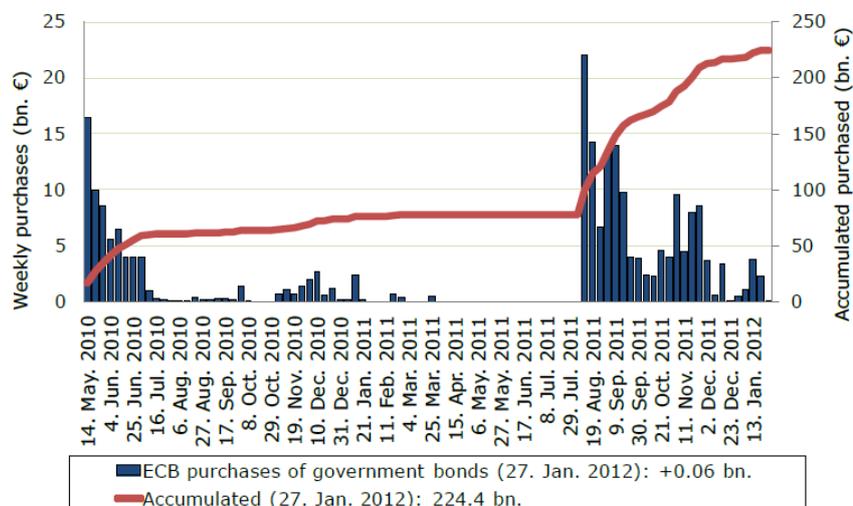
As pointed out by Frank Veneroso⁴, the ECB’s balance sheet has expanded almost 50% in the last six months to €2.7 trillion and it doesn’t stop there. The balance sheets of the 17 eurozone central banks have grown even faster and now add up to €1.7 trillion, creating a consolidated balance sheet in the European central bank system of €4.4 trillion, almost twice the size of the Fed’s balance sheet. And this is *before* you add in the €489 billion provided through the LTRO

³ Source: <http://www.debtdeflation.com/blogs/2012/01/28/economics-in-the-age-of-deleveraging/>

⁴ ‘Big ESCB QE’, Veneroso Associates, 16 January 2012.

programme announced on the 8th December⁵. This certainly hasn't gone unnoticed in European equity markets which have performed much better since the announcement.

Chart 3: ECB Bond Purchases Exploded in 2H2011

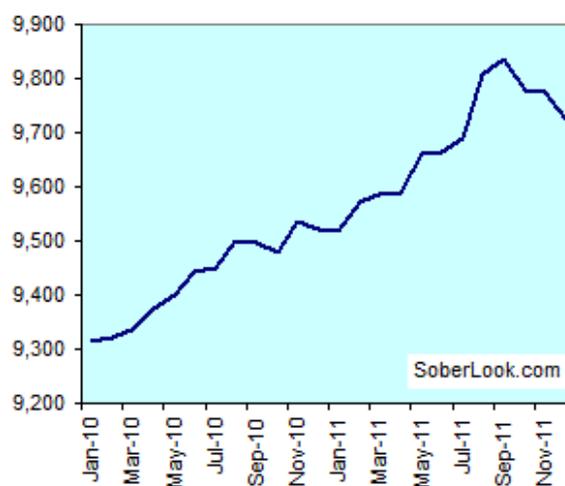


Source: Bankinvest

What's more, European banks are set to more than double their crisis loans from the ECB when the next LTRO auction opens on 29th February according to a survey in the Financial Times (see [here](#)). The conclusion is crystal clear: It is not a question of whether the ECB should or should not engage in QE. The ECB is already knee deep in a QE programme that has been firing on all cylinders since last August, and there is *a lot more* to come.

There is no question that the liquidity made available by the ECB has eased the liquidity squeeze in the European banking system and thus provided some much needed energy to the equity markets; however, in order to fully understand what is going on, you need to look at chart 3 in conjunction with chart 4. It is no coincidence that M3 (a broad measure of money supply) has begun to fall at the same time as the ECB has expanded its balance sheet aggressively.

Chart 4: Eurozone M3 in Decline



Source: Soberlook.com. Note: All numbers in billion euros, seasonally adjusted

⁵ LTRO stands for Longer Term Refinancing Operations which is a funding programme offered to the eurozone banks by the ECB whereby the banks can fund themselves on attractive terms. The programme announced in December offered three year loans.

As the crisis in the European banking industry has mounted over the past couple of years, the only type of interbank lending that has continued to work well is repo lending (secured lending usually, but not necessarily, with government bonds provided as security), but repo lending is not ideal for banks in the current environment as it is mostly short term finance.

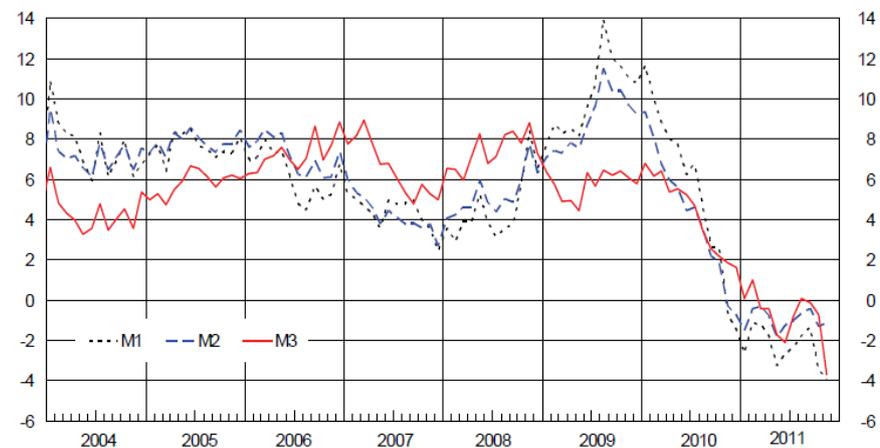
Having the ability to finance their liquidity needs longer term would give the banks much needed stability and that is precisely what the ECB programme provides and why so many banks took up the ECB offer. This has had the effect of draining the interbank market of collateral (which is now with the ECB). Since repos are included in the M3 but secured lending provided by the ECB is not, the M3 drops as banks shift from the repo market to the ECB.

You may say, so what? However, this is not only of academic relevance. Obviously the need for the ECB to step in and offer an alternative to repo funding is a signal that the credit conditions in Europe are far from ideal. If one drills one level deeper, it is possible to obtain information as to which countries have seen the biggest drop in repo funding, which should be a proxy for relative credit conditions. Not surprisingly, Italy accounts for almost 50% of the drop in repo funding with Spain accounting for almost 20% and Belgium for about 15% (see [here](#) for details).

Now, this information has been used by some commentators to suggest that Italy is being suffering a slow and painful death in the euro system. Ambrose Evans-Pritchard wrote a stinging article in the Daily Telegraph a couple of weeks ago, suggesting that “The euro is pushing Italy into depression” (see [here](#)). Using chart 5 below, he argued that:

“There is no clearer indictment of the dysfunctional nature of monetary union. Italy is being pushed into depression. Criminal.”

Chart 5: Italy’s Contribution to Euro Area Monetary Aggregates



Source: Banca d'Italia. Note: 12-month percentage changes

Now, remember what I said earlier. Repos count towards M3. ECB secured funding doesn't. So, when Italian banks move away from the repo market and fund themselves through the ECB instead, the effect on M3 will be profound. Italian banks are much better off with the ECB programme but M3 looks ugly as a result. Sometimes there is more to the story than first meets the eye.

Which brings me to one of my pet hates. The emergence of the internet as a provider of (usually) independent and (occasionally) high quality research has made it more important than ever not to take everything you read at face value. I am referring to the thousands of market commentators cum economists (let's just call them bloggers although, strictly speaking, they don't all blog) who see it as their call in life to

comment on every bit of economic and market news, whatever the relevance to the rest of us.

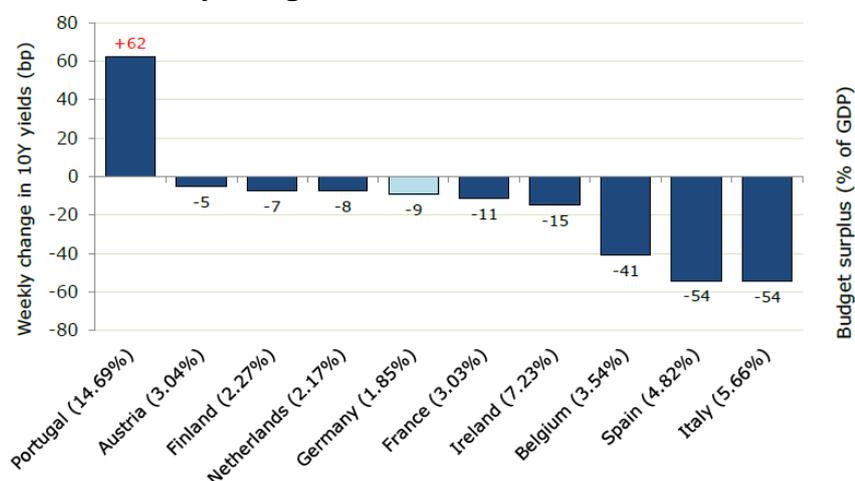
Now, I shall be the first to admit that many bloggers do a very respectable job and their services are certainly needed as an antidote to the self-promoting investment banks which have always done – and always will do - everything in their power to talk the markets up. Having said that, many bloggers are as negatively biased as the investment banks are positively inclined, so the neutral needs to understand that there is bias in both camps.

The other and bigger problem is that most bloggers do not manage money. Talk is cheap when there is no accountability. Back in the late 1990s, fund manager Tony Dye became a household name in the UK for sticking to his view that equity markets were dramatically overvalued. His employers began to lose clients and finally lost patience with Tony who was sacked in February 2000 (no points for guessing when the markets topped out). Tony was a fund manager with great vision who was prepared to stand by his views, but he paid the price for getting his timing wrong⁶.

Where am I going with this? You are about to find out. In the blogging sphere timing rarely matters. Bloggers can operate on a completely different level from market practitioners, and most of them do. Good friend and fellow investment manager Kim Asger Olsen of Origo (see [here](#)) refers to it as Economists' Hypothetical Time (EHT) versus Real Market Time (RMT). His point – and I wholeheartedly agree – is that, whereas market practitioners (those who manage money and thus have an effect on markets) are forced to operate in RMT if they have any desire to make money for their clients, bloggers tend to work in EHT (this is a polite way of saying that they dwell for too long on what already belongs in the past in RMT).

Market practitioners no longer care about Greece. Neither do they care about Portugal for that matter. In RMT these countries no longer matter in the bigger scheme of things (to my friends in those countries: don't take it personally, but that is the reality). So, when Portuguese bond yields blow out as they have done in the last week (chart 6), the reaction in the markets is muted to say the least. EHTers think it spells the end of the world. RMTers, on the other hand, know that Portugal doesn't need to finance itself through the bond markets for at least another 30 months. Hence they ignore the Portuguese predicament. Instead they are now entirely focused on whether Italy and Spain can ride out the storm and, on the evidence of the recent performance of European markets, the verdict is that they can.

Chart 6: Weekly Change in Eurozone Bond Yields



Source: Bankinvest. As at 1 February 2012.

⁶ Sadly, Tony Dye passed away in 2008.

Much of the €489 billion that the ECB dished out in December has come back into the coffers of the ECB as overnight deposits (which may have disappointed the ECB somewhat) but, irrespective of that, the programme still did the bond markets in the eurozone's periphery a world of good. Charts 7 a-b below show the Spanish and Italian yield curves as at 7 December (the day before the ECB announcement) and [28 January] respectively. The improvement is significant, in particular on 2-4 year maturities where the effect of the LTRO has been the greatest.

We can debate from now 'til the cows come home whether Italy can afford to pay 6% on its 10-year debt, and that is precisely what occupies the minds of those operating in EHT, but what matters to RMTers is that Italy can finance itself cheaper now than they could 8 weeks ago. Doomsday has moved further away and equity markets have reacted accordingly. Who said QE doesn't work?

Chart 7a: Spanish Yield Curve

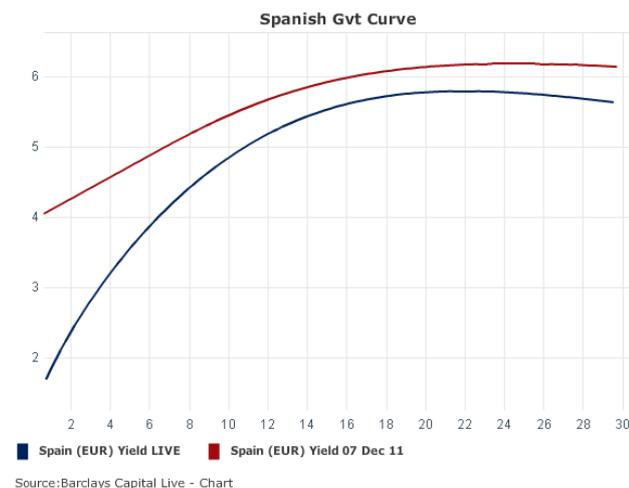
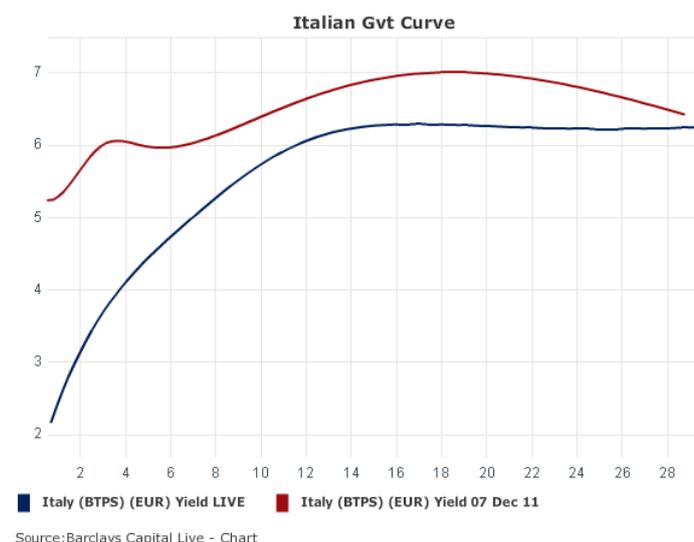


Chart 7b: Italian Yield Curve



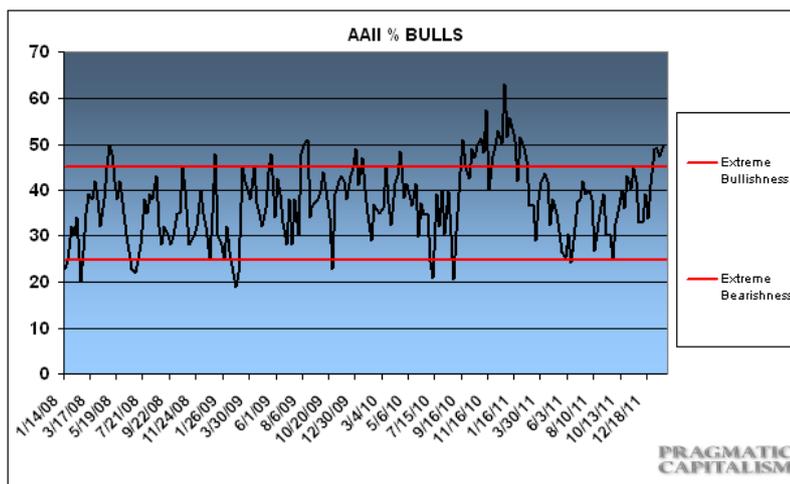
Now to the \$64 million question: Are we in the early stages of a major new bull trend or is it simply a bear market rally? Most EHTers will tell you it is the latter. RMTers are divided. Let's look at some of the risks before I reveal where I stand.

Few people would probably disagree that the biggest risk facing the world today is the unfolding eurozone crisis but, as I have at least

attempted to demonstrate with this piece, that crisis is now in decline, at least temporarily. I say temporarily, because there can be no doubt that the ECB has not solved the eurozone crisis yet. All it has achieved so far is that it has bought a not inconsiderable amount of time which is no small accomplishment given the near meltdown only a few months ago. On that basis, the equity rally is more than justified.

But the eurozone crisis is not my only worry. After a decent run in equity markets, individual investor euphoria is on the rise and is now in dangerous territory – at least in the US (chart 8). This is not a dead sure indicator, but when sentiment reaches these levels, it often precedes a sell-off (small or large).

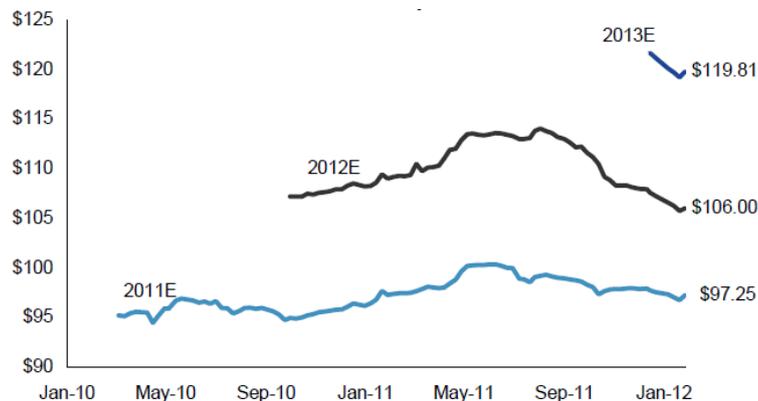
Chart 8: Investor Sentiment in Dangerous Territory



Source: American Association of Individual Investors, Pragmatic Capitalism

If individual investors are perhaps getting a bit carried away, Wall Street analysts certainly aren't. Earnings estimates for 2012 have come down significantly over the last few months (chart 9) at a time where the US economy has surprised pretty much everybody by its strength. This doesn't add up. Are analysts overly pessimistic (not usually in their DNA) or is this an indication that the current upswing in US economic fundamentals will prove short-lived? The last thing Europe needs now is for the US to lose momentum again. It can hardly afford it.

Chart 9: US Earnings Estimates Under Pressure



Source: Morgan Stanley

I wish the list would stop there but it doesn't. I am concerned about China (don't think they tell the truth about the true extent of the current slowdown) and I agonize over the situation in Iran (the world economy is too fragile right now to withstand an oil price at \$150). Most of all, I

worry about pension liabilities in Europe (see [here](#)) which continue to grow without any serious attempts being made to address the problem.

In other words, there is plenty to keep me awake at night; however, to use an old cliché, equity bull markets have always had to climb walls of worry and this is no different. At least for now, valuations are sufficiently attractive (see our October 2001 letter [here](#) for a detailed discussion of current valuation levels) to keep this bull market going.

Is it the beginning of a structural bull market? I doubt it. We are still in a risk-on / risk-off environment where investors blow hot and cold. One of the fallouts of the crisis of the past 3-4 years is a shortening of investors' time horizon (stat of the day: did you know that the average holding period for US equities is now 22 seconds??). Long term investors have become an endangered species and the effect on markets is there for everyone to see. I doubt this will change any time soon but, for now, it is risk on.

This is not the time to be fully invested but neither is it the time to be side lined. We are in a nervous market where great opportunities present themselves at regular intervals. We recommend holding 25-50% in cash or cash like instruments (depending on your risk profile) which can be deployed at short notice when those opportunities arise.

We have recently produced a brief strategy document where we outline a number of investment strategies which we believe fit into this type of environment. This document is available to clients of Absolute Return Partners. Please contact either Nick Rees or myself if you would like a copy.

Niels C. Jensen

3 February 2012

© 2002-2012 Absolute Return Partners LLP. All rights reserved.

⁷ Source: Societe Generale

Important Notice

This material has been prepared by Absolute Return Partners LLP ("ARP"). ARP is authorised and regulated by the Financial Services Authority. It is provided for information purposes, is intended for your use only and does not constitute an invitation or offer to subscribe for or purchase any of the products or services mentioned. The information provided is not intended to provide a sufficient basis on which to make an investment decision. Information and opinions presented in this material have been obtained or derived from sources believed by ARP to be reliable, but ARP makes no representation as to their accuracy or completeness. ARP accepts no liability for any loss arising from the use of this material. The results referred to in this document are not a guide to the future performance of ARP. The value of investments can go down as well as up and the implementation of the approach described does not guarantee positive performance. Any reference to potential asset allocation and potential returns do not represent and should not be interpreted as projections.

Absolute Return Partners

Absolute Return Partners LLP is a London based client-driven, alternative investment boutique. We provide independent asset management and investment advisory services globally to institutional as well as private investors..

We are a company with a simple mission – delivering superior risk-adjusted returns to our clients. We believe that we can achieve this through a disciplined risk management approach and an investment process based on our open architecture platform.

Our focus is strictly on absolute returns. We use a diversified range of both traditional and alternative asset classes when creating portfolios for our clients.

We have eliminated all conflicts of interest with our transparent business model and we offer flexible solutions, tailored to match specific needs.

We are authorised and regulated by the Financial Services Authority.

Visit www.arpllp.com to learn more about us.

Absolute Return Letter Contributors

Niels C. Jensen njensen@arpllp.com tel. +44 20 8939 2901

Nick Rees nrees@arpllp.com tel. +44 20 8939 2903

Tricia Ward tward@arpllp.com tel: +44 20 8939 2906

Thomas Wittenborg wittenborg@arpllp.com tel: +44 20 8939 2902