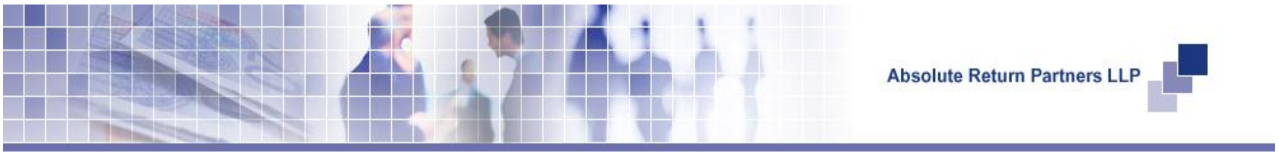


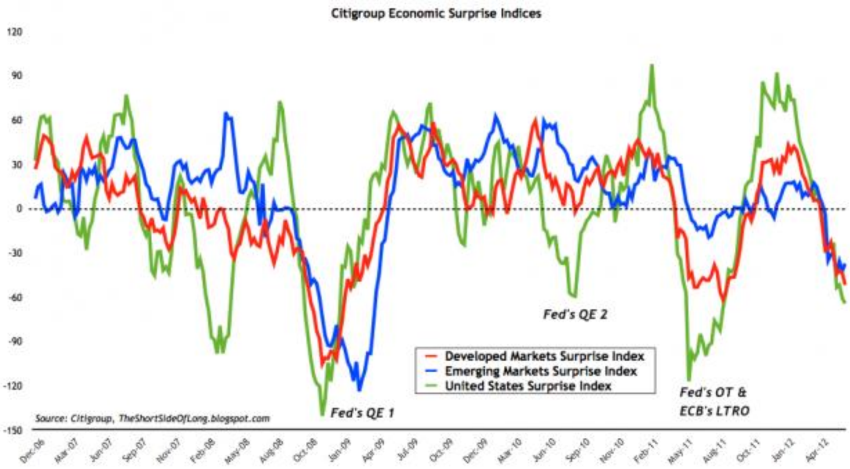
The Absolute Return Letter
July 2012

Looking for Bubbles

A deteriorating outlook

Recent weeks haven't offered much fodder for the optimists of this world. Eurozone leaders continue to rely on their central bankers to do the dirty work and the dithering is beginning to have an effect on consumer and business confidence across the world. What was meant to be a relatively shallow European recession this year now threatens to become something far more serious (chart 1).

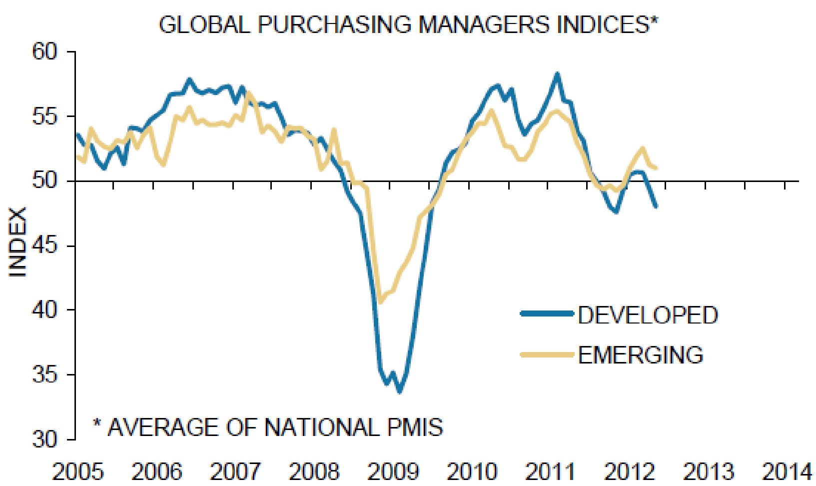
Chart 1: A Deteriorating Economic Outlook



Source: Citigroup

Recent PMI data confirms the negative trend in economic activity (a PMI reading below 50 is consistent with negative GDP growth). In our view, a European recession is already baked in the cake. Meanwhile, in the U.S., a (mild) recession is starting to look like more than just a perma bear's fantasy (chart 2).

Chart 2: Recent PMI Data Points towards a Global Slowdown



Source: Morgan Stanley Research

The slowdown is structural

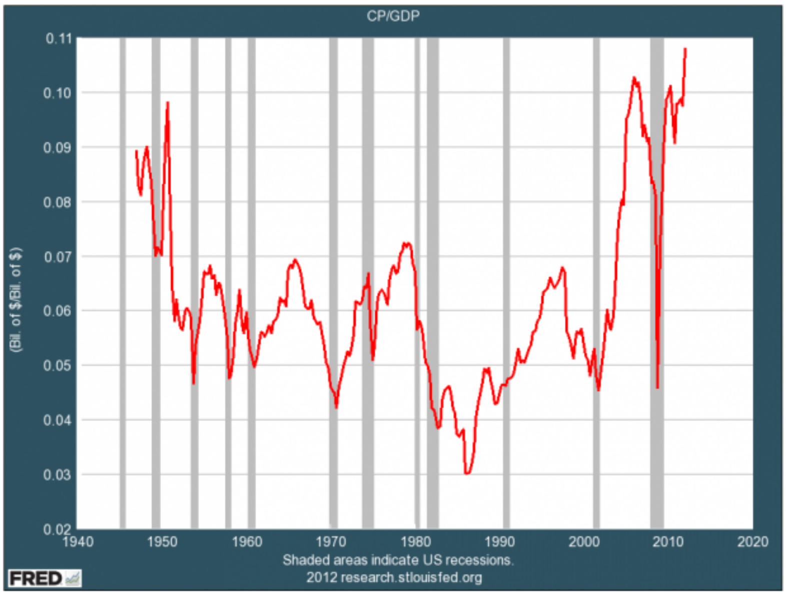
In Asia, China appears particularly vulnerable at this point. As I have pointed out repeatedly, the official macroeconomic data coming out of China is misleading even at the best of times. I feel tempted to quote Geraldine Sundstrom, the well-known emerging markets fund manager at Brevan Howard who is fond of saying: "Don't listen to what the Chinese authorities say. Look instead at what they do." I decided to do just that and found that they have recently slammed a 20% vacancy tax on undeveloped land (see here). That is a genuinely drastic measure and supports my long held thesis that the Chinese slowdown is more pronounced than the China bulls are prepared to admit.

A cyclical slowdown is not the only challenge the Chinese are facing. The urbanisation of the country is slowing from an estimated 3-4% over the past decade to 1-2% over the next decade. The labour pool is peaking as we speak and demographics will become an increasingly negative factor in the years to come, all of which suggest that annual GDP growth in China is likely to slow to 5% or even less in the not so distant future.

The one mitigating factor, not only for China but for all oil consuming nations, is the recent drop in oil prices. Whilst its impact should not be exaggerated, falling oil prices are akin to a tax cut. A $20 fall in the price of crude translates into a 1% transfer of wealth from oil producing nations to oil consuming nations. As the consumption rate is higher in oil consuming countries, the net effect of a $20 drop in the price of crude oil is an increase in global GDP of about 0.5% (see here).

Interestingly, I find that many American investors are oblivious to much of this. They have for the most part pulled out of Europe and are thus focused mainly on domestic developments. As U.S. corporate profit margins continue to impress (chart 3), there seems to be a belief across the pond that U.S. corporates are well protected against events in Europe. I have a sneaking feeling that is about to change. Let's see. U.S. corporates will begin to report second quarter earnings in the next few days. It will make for some interesting reading.

Chart 3: All-Time High U.S. Corporate Profit Margins



Source: http://www.businessinsider.com/corporate-profits-just-hit-an-all-time-high-wages-just-hit-an-all-time-low-2012-6. There is more information to be found on http://www.federalreserve.gov/releases/z1/current/z1.pdf (see section F7).

Is Asia a bubble about to pop?

You may wonder where I am going with all of this. None of the above is rocket science but it is highly relevant in the context of the discussion I opened in the May Absolute Return Letter - where will the next asset bubble surface? As I have stated repeatedly in recent months, current monetary policy is conducive to the creation of echo bubbles. It is only a question of where and when.

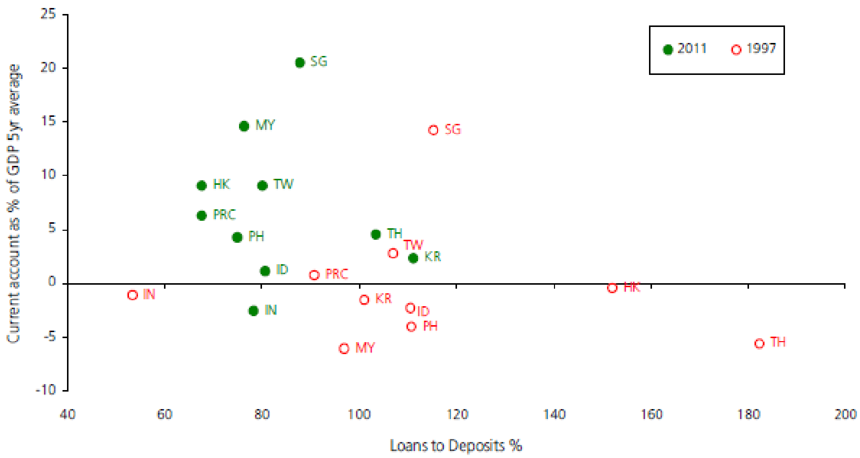
I documented in the May letter that policy rates throughout Asia are dangerously low (see here), but does that translate into imminent danger? Allow me to recap what I wrote two months ago:

"A Perfect Financial Storm will occur when (1) investors have bets based upon very similar forecasts, (2) their bet is a 'big' one, for example, a bet on the price of their principal asset (their house), and (3) both investors and their banks are maximally leveraged."[1]

Asia arguably meets the first two conditions but not the third one yet. Paraphrasing the work of Duncan Wooldridge at UBS[2], the credit cycle begins with several years of growth in debt-to-income ratios, usually fuelled by easy access to cheap credit. The readily available credit leads to a growing misallocation of capital, causing an increase in non-performing assets. This is the second stage of the credit cycle and is broadly speaking where Asia finds itself today.

The third stage is the critical point where loan-to-deposit ratios in banks reach an unsustainable level. As a result, liquidity and funding problems become more prevalent and non-performing loans grow dramatically. As is evident from chart 4 below, loan-to-deposit ratios are still well below the levels experienced in 1997. Moreover, most Asian countries (ex India) are creditor nations today, providing them with a cushion they didn't have in 1997.

Chart 4: Asia Today is Healthier than Asia in 1997



Source: UBS

In the short term at least, the key challenge for Asia is its continued reliance on exports. The domestic sector is still too small to compensate for a dip in demand from overseas. This is illustrated in chart 5, courtesy of PIMCO. On average, every 1% increase in the U.S. current account deficit leads to a corresponding 1% increase in GDP growth across emerging markets.

In the aftermath of the 1997-98 crisis countries across Asia learned that they could export their way to prosperity. All it requires is a mercantilistic approach (read: artificially low exchange rates) and something the rest of the world is prepared to buy. Asia has since gone from strength to strength with almost every Asian country having accumulated large foreign exchange reserves over the past 15 years (see here), yet only Singapore's currency has appreciated in value against the U.S. dollar since the mid 1990s. It is a testament to the lack of political leadership, and the sheer stupidity, we have suffered from in the West in recent years. The Asians must be laughing all the way to the bank. For the record, I don't blame the Asians. They are only doing what everybody else would be doing if offered the opportunity. I blame the imbeciles running the asylum in this part of the world.

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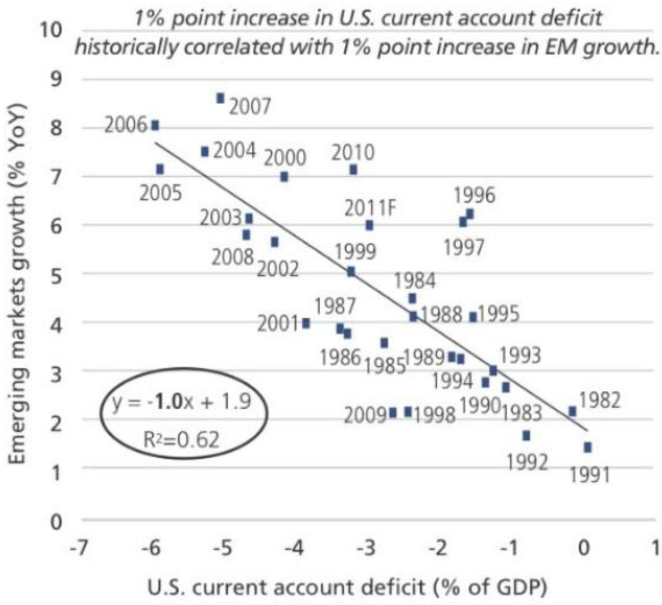
[1] *Source: Woody Brock*
[2] *Source: The Great Asian Monetary Theme, UBS, 31 May 2012*

Chart 5: The U.S. Deficit Drives Emerging Market Growth

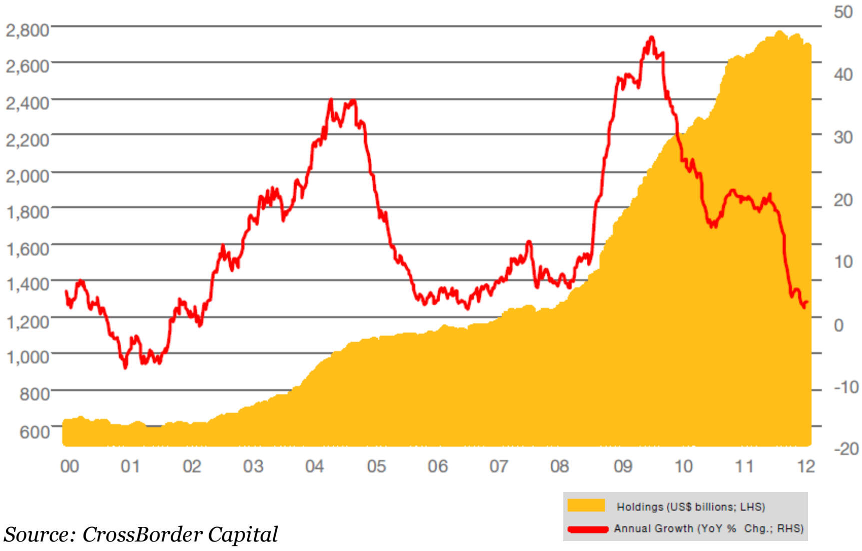


Source: PIMCO

Countries that run persistent current account surpluses traditionally place a large proportion of their foreign exchange reserves in U.S. treasuries. These are usually held in custody by the Federal Reserve Bank. The growth in such holdings has slowed to a trickle in recent months (chart 6), suggesting a material slowdown in Asian exports to the U.S.

If you further consider that the monetary base in many emerging economies is defined by the size of their foreign currency reserves, the inescapable conclusion is that the liquidity picture across Asia is deteriorating. On the margin, this raises the probability of a negative credit event in Asia (the third stage of the credit cycle referred to above) happening sooner rather than later. However, in all likelihood, such an outcome is probably not months but years away.

Chart 6: Foreign Holdings of USTs Held in Custody by the Fed

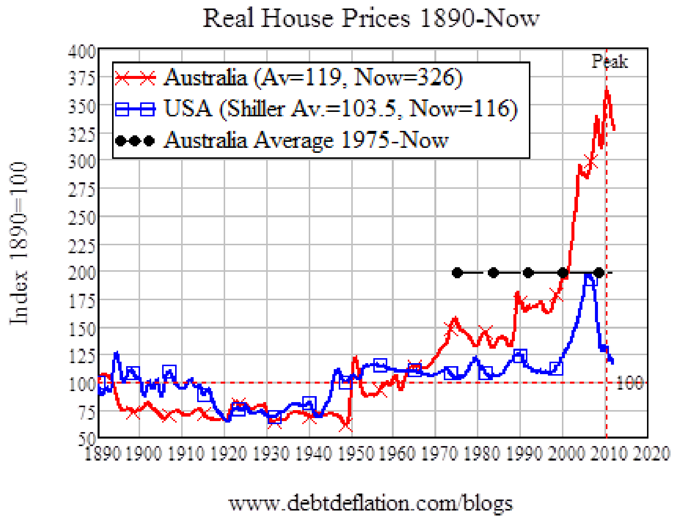


Source: CrossBorder Capital

Australians in denial

A much more likely candidate for a near term blow-up is the Australian property market with its inflated prices (chart 7). The counter-argument is the vast amount of wealth which has been created in Australia in recent years as a result of the boom in the mining industry - an argument which was put forward by several readers following last month's letter.

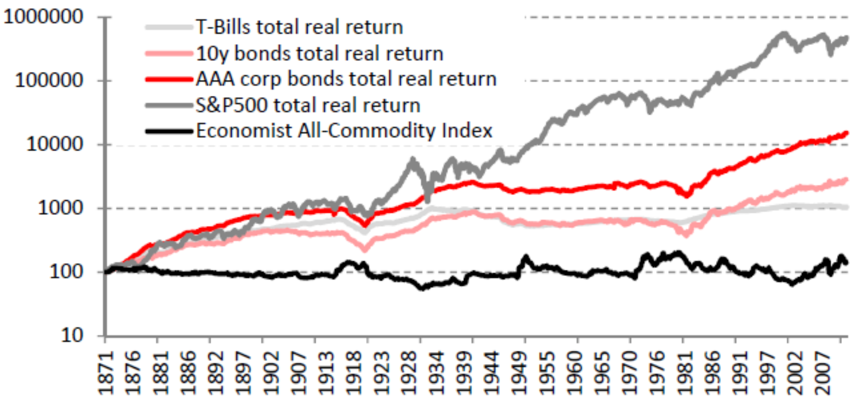
Chart 7: Australian Property Prices in Bubble Territory



Source: Steve Keen's Debtwatch

Now, that argument would be perfectly valid if it wasn't for the fact that commodity prices follow a rather predictable pattern – on average about one decade of strong price appreciation followed by two decades of falling prices – and we are coming to the end of a decade of strong commodity prices. In the long run, this has resulted in commodity prices going practically nowhere (chart 8).

Chart 8: Commodities for the long run, anyone?



Source: SG Cross Asset Research

Another, and admittedly slightly less academic, way of looking at things is to compare the current bull cycle in commodity prices with the dot com boom in the late 1990s. At the height of the dotcom boom some 12-13 years ago, high tech stocks accounted for about 25% of global market capitalisation, and the boom had created 75 dollar billionaires in the IT industry versus only 29 coming from the energy industry. A good decade later these numbers have completely reversed. It is now commodity stocks (energy and materials) that account for one-quarter of the global market value and we have 91 energy related dollar billionaires versus 36 coming from the IT world[3]. A sign of things to come?

The alert reader should by now have figured out that I don't buy the 'this time is different' argument put forward by the commodity bulls. Loyal followers of the Absolute Return Letter will know that I am a firm believer in human ingenuity (see for example here). Creativity and resourcefulness will ultimately prevail which explains why commodity prices go nowhere in the long run. The one exception I make to this rule

[3] *Source: Ruchir Sharma, Morgan Stanley (see here).*

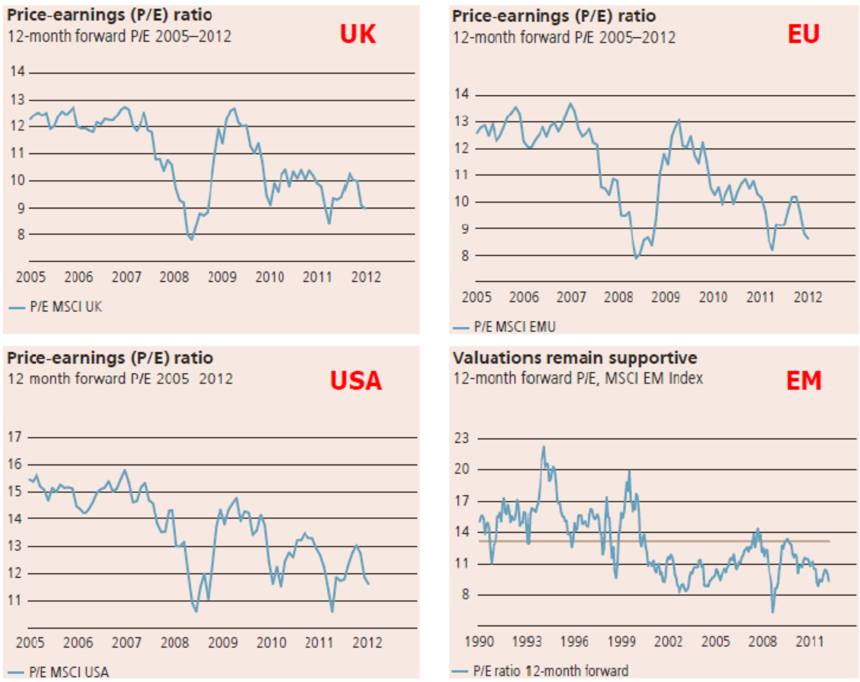
is agricultural commodities; we have not yet figured out how to produce artificial protein on a commercial scale, although we may not be too many years away from that either (see here).

Other bubble candidates

Bonds are referred to by many as being in bubble territory. I don't buy that argument. Bond prices are controlled politically these days. I still remember the first year at university when we were told that the central bank controls the short, but not the long, end of the curve. Not anymore. What's more, our central bankers know only too well that the global economy is extremely fragile and that an increase in rates, at both ends of the curve, could have catastrophic consequences. I do not expect a material increase in yields anytime soon and I have absolutely no intentions of betting against my own government with its virtually unlimited resources. That is a bet I would almost certainly lose.

Equity prices at current levels are looking quite attractive (chart 9). Even if there is some short term cyclical risk to earnings, and thus to valuations, it is hard not to be long term bullish. We just need some clarification on the Eurozone problems so the world can move forward again. My money is on Merkel grabbing the bull by the horns in the next six to nine months so that it doesn't become too big a theme in the German parliamentary elections later next year.

Chart 9: Equities Are Attractively Priced for the Long Term

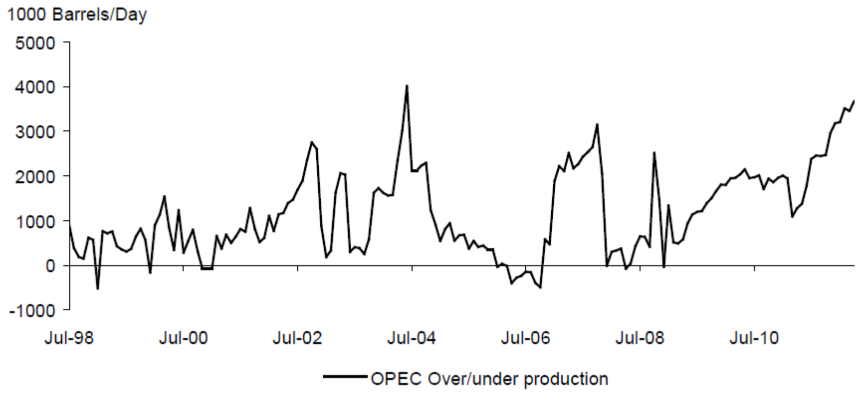


Source: UBS. Valuations updated through May 2012.

That leaves commodities, and crude oil in particular, as my only other serious candidate for the 'bubble that is about to burst' prize. There is a serious glut of oil in the world at the moment. U.S production has been ramped up dramatically in the last 12 months. Libya and Iraq have both come back faster than expected. Meanwhile, most OPEC producers continue to cheat (chart 10) and all of this is happening in an environment of slowing economic growth.

In the interim, money has continued to come into commodity based funds. According to estimates from Morgan Stanley, commodity assets under management worldwide have more than doubled in the last five years to over $400 billion and the daily trading volume in energy futures is now a whopping 25 times the daily demand for energy.

Chart 10: OPEC Producers Are Notorious Cheats



Source: Macquarie Research

If the global economy continues to weaken and oil producers don't adjust their production accordingly, there is a pretty good chance of crude oil prices coming back further which would be a great tonic for the global economy going into 2013.

Conclusion

So it is not all doom and gloom. We are staring into a cyclical downturn in the second half of this year. Behind that is a whole other set of challenges, more structural in nature, which will take years to sort out. Our American friends - except for a small but rather vocal minority – won't accept that they have their own set of problems which are quite serious. Our Asian friends will continue to 'cheat' their way to prosperity until we put our foot down. And the Europeans will argue 'til the cows come home about what is the right remedy for our disease whilst society as we know it unravels around us.

But, as Churchill used to say (and I paraphrase), they will eventually make the right decisions once they have pursued every other avenue. It is precisely for that reason that equities are cheap. We just don't know how long it will take. If my inkling about Merkel is right, the next equity bull market is not that many months away.

Cheer up and enjoy the summer. Back in September…

Niels C. Jensen
4 July 2012

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