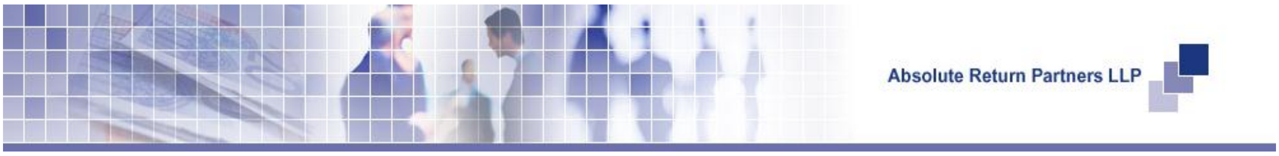


The Absolute Return Letter November 2012

The Era of Kakistocracy

Kakistocracy *(noun): Government by the worst citizens. For reasons which can only be speculated upon, there is no word for government by the best citizens.*[1]

We are now five years into a crisis that just doesn't want to go away. Paraphrasing Charles Gave of GaveKal who wrote a supremely succinct paper on this topic only last week[2], policy makers continue to tamper with interest rates, foreign exchange rates and asset prices in general. They continue to permit deposit-taking banks to operate like casinos. They issue new debt to pay for expenditures when we are already drowning in debt. They just don't seem to get it. Albert Einstein once defined insanity as doing the same experiment over and over again, expecting a different result. QE1. QE2. QE3... Need I say more?

Meanwhile, more and more investors appear convinced that all this tinkering will end in inflation. Some even expect a lot of it. That is what this month's Absolute Return Letter is about. Are bonds a safe investment at current levels? Could we possibly be in a bubble? In the tug-of-war between inflationary and deflationary forces, will inflation ultimately prevail? What could happen to bond prices if any of this comes to fruition?

Inflation vs. deflation

I first wrote about inflation vs. deflation in July 2009 (see here). A lot has happened in the interim, suggesting that now is a good time to re-visit the subject. Let's begin by establishing our fundamental position, which hasn't changed much since 2009. Back then I concluded:

"If my worst fears are proven correct and we have to fight a bout of deflation, the authorities will have no choice but to try and provoke price increases through aggressive policy measures. Otherwise entire countries could be bankrupted as they suffocate in their own debt. Whether it will work is a different story."

Three years on, I remain absolutely convinced that deflation, driven primarily by consumers eager to repair their balance sheets, will be a powerful force for many years to come but, at the same time, I must admit that I see worrying signs of inflation expectations beginning to creep in.

Now, before going any further, perhaps I should define inflation. Here it is appropriate to distinguish between asset price inflation and consumer price inflation. Most observers of financial markets would probably agree that, on balance, asset prices have benefitted from the combined actions of the world's central banks over the past few years, so it seems fair to suggest that we already suffer from at least some degree of asset price inflation.

Consumer price inflation is a different beast altogether. The future path of consumer price inflation is to a large degree dictated by current inflation expectations. As is well established in economic theory, rising inflation expectations may change our behavioural patterns, which again

[1] *"The Superior Person's Book of Words", Peter Bowler*
[2] *"A Simple World", GK Research, 2 November 2012*

may lead to a rise in actual inflation; hence inflation expectations are an important leading indicator of future inflation trends.

It is indeed possible to have asset price inflation without consumer price inflation and vice versa. Alternatively, the two types of inflation may also go hand in hand. What we are experiencing at the moment is a somewhat unusual combination. Asset price inflation in the 'old' world has led to consumer price inflation in emerging economies, mainly through rising commodity prices.

Having said that, there is no law of economics to suggest that the commodity price induced increase in consumer prices in emerging economies must ultimately lead to an increase in consumer prices in our part of the world. We don't have to go more than 30 years back to find a prime example of very high consumer price inflation in one country (the United States) not leading to the same dramatic rise in consumer price inflation in one of its key trading partners (Western Europe).

More recently, the Federal Reserve Bank and, by implication, other central banks as well, have been heavily criticized for not delivering economic growth through QE. However, I am not at all convinced that economic growth is in fact the primary objective of QE. Bernanke is a life-long student of the Great Depression and understands deflation, and the damage it can inflict, better than most of us. If you go through his speeches and statements of recent years, there is plenty of evidence to suggest that he takes the risk of deflation very seriously, and his continuous commitment to QE is probably as much a reflection of those concerns as it is a policy that he realistically expects can accelerate economic growth.

Five possible paths

So, with that in mind, *when* will interest rates begin to rise outside of the European periphery? Many of those countries that enjoy record low interest rates today mainly do so because they have achieved safe haven status as the crisis along the Mediterranean coastline has deepened.

Financial history is littered with evidence that asset prices do not stay stable for long, so I feel very comfortable when I ask the loaded question *when?* Our analysis suggests that there are at least five possible paths which may lead to higher interest rates (conveniently ignoring some shorter term cyclical and technical reasons which won't be part of this discussion):

1. The expansion of the balance sheets of the Fed, the BoE, the ECB and the SNB could ultimately lead to a rise in consumer price inflation in the U.S. and Western Europe.

2. Once central banks begin to shrink their balance sheets again, asset prices could come under pressure with interest rates going up as a result.

3. The crisis in the European periphery could spread to other countries as the true extent of the over-leverage becomes apparent (Japan, France, Belgium and Slovenia have all received regular mentions in the financial media).

4. The crisis in the European periphery could begin to abate, causing investors to pull out of the safe havens only to move back in to the periphery, causing spreads between the safe havens and the European periphery to narrow.

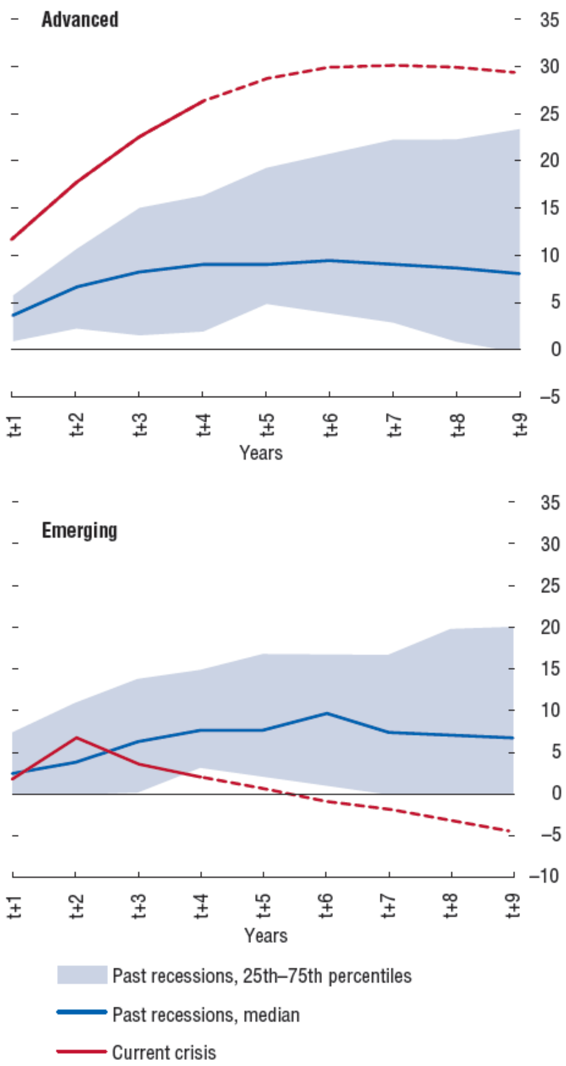
5. The crisis in the European periphery could linger on, but with the rest of the world paying less and less attention and hence, away from the crisis countries, some sort of normality could return with interest rates normalising, whatever 'normal' means these days.

(Please note that these outcomes are not necessarily mutually exclusive.)

Before I take a closer look at each of those five possible outcomes, I need to address a fallacy which will play an important role in the following. Many believe that sovereign de-leveraging is now well under way and that the austerity programmes put in place in various countries will begin to pay dividends soon. The reality is that governments have not even begun the de-leveraging yet!

Most so-called advanced countries (as defined by the IMF – I sometimes question how advanced these countries really are) are significantly more indebted today than they were in 2007, prior to the outbreak of the current crisis (chart 1). The U.S. and Canada, most eurozone countries as well as the U.K. and Japan are all on that rather unflattering list.

Chart 1: Cumulative Change in Gross Debt since Start of Recessions (% of GDP)



Source: IMF Fiscal Monitor, October 2012.
The solid red line corresponds to 2009-12 and the dashed line to 2013-17.

There are several other interesting observations to take away from the chart above. Generally speaking, emerging economies have done a much better job than advanced economies in terms of controlling their debt during this crisis (bottom half of chart 1). Secondly, it is clear how outsized this crisis is relative to prior recessions (red line vs. shaded area in top half of chart 1). Finally, and most importantly, you can see how debt will continue to grow at least until 2015 (t+7), when the IMF expects debt-to-GDP to peak, following 7 years of debt accumulation. I will take almost any bet you put on the table that, bar a major sovereign restructuring and/or default between now and 2015, the IMF projection will prove too optimistic.

I should also mention that chart 1 refers exclusively to government debt. Corporate balance sheets outside the banking sector are generally speaking in good shape. Household balance sheets are a mixed bag but improving overall. Banks are a mess (chart 2).

Chart 2: Indebtedness and Leverage in Selected Countries

		General Government			Households		Nonfinancial Firms		Financial Institutions			External Liabilities		
		Gross debt[2]	Net debt[2,3]	Primary balance[2]	Gross debt[4]	Net debt[4,5]	Gross debt[4]	Debt over equity (percent)	Gross debt[4]	Bank leverage[6]	Bank claims on public sector[4]	Gross[4,7]	Net[4,7]	Government debt held abroad[8]
Euro area	Greece	171	n.a.	–1.7	69	–58	73	235	40	n.a.	13	204	96	95
	Ireland	118	103	–4.4	117	–74	289	109	706	8.3	28	1,750	99	71
	Italy	126	103	2.6	51	–174	114	138	105	5.2	38	146	24	46
	Portugal	119	113	–0.7	104	–125	158	154	59	4.5	24	285	108	64
	Spain	91	79	–4.5	87	–74	186	143	115	4.9	35	225	92	25
	Belgium	99	83	0.1	55	–202	186	52	123	n.a.	24	404	–65	57
	France	90	84	–2.2	67	–134	134	68	172	2.5	18	296	16	58
	Germany	83	58	1.4	58	–122	64	96	97	2.2	23	219	–38	51
	Euro area	94	73	–0.5	71	–130	138	107	145	n.a.	n.a.	194	12	26
Rest of the world	United Kingdom	89	84	–5.6	99	–185	116	85	232	4.2	8	692	9	28
	United States	107	84	–6.5	86	–235	89	83	88	7.1	8	161	26	32
	Canada	88	36	–3.2	91	–154	54	44	59	3.3	15	103	12	18
	Japan	237	135	–9.0	76	–241	145	176	188	2.8	83	73	–57	18

Source: IMF Global Financial Stability Report, October 2012.
Note: See footnotes on page 22 of the report which you can find here.

#1: Will QE lead to inflation?

So, with that in mind, let's go back to the five possible paths outlined above and ask the question: Will the monetary expansion ultimately lead to inflation? The simple answer is 'not necessarily'. Since the Federal Reserve Bank embarked on QE, its balance sheet has grown by almost $2 trillion. This is money the Fed has paid out in exchange for the securities it has bought through the primary dealers[3] in the U.S. market place.

The vast majority of the $2 trillion now sits in the reserve accounts that each of the primary dealers hold with the Fed. No new money has been printed as a result and, as long as the money stays in the reserve accounts, it will have zero effect on the broader economy and hence on inflation. Now, let's assume that consumers and speculators regain their appetite for borrowing. It won't be long before one or more of the primary dealers conclude that, with all those reserves, why not get back on the dance floor? Banks could possibly lend 8-10 times those reserves so, in principle, there is now almost $20 trillion in new lending capacity in the U.S. banking system as a result of the QE programme. (Similar calculations could be made for other countries.)

Now, *that* would be highly inflationary and it is precisely for that reason that many get scared by the possible implications of QE. However, there is one additional piece to the jigsaw which has not been revealed yet, and which is not widely understood. In 2008 a new law was passed in the U.S., permitting the Fed for the first time to pay interest on reserve accounts held with the Fed. With that new policy tool in hand, all the Fed would have to do would be to raise the interest paid on the reserve accounts to a level that would discourage reckless lending. For that reason alone, I believe the risk of runaway inflation as a result of the expansion of central banks' balance sheets that we have witnessed in recent years is grossly exaggerated.

#2: When QE is reversed

Now to the second possible path. The question is a simple one: Will rates rise when central banks begin to unwind the securities they have acquired in recent years? The answer is equally straightforward. Prior to 2008, the Fed would have had to eventually soak up the excess liquidity by selling those securities they had previously acquired. However, with the introduction of the new policy tool that came with the Reserve Remuneration Act of 2008, the Fed may never have to offload those

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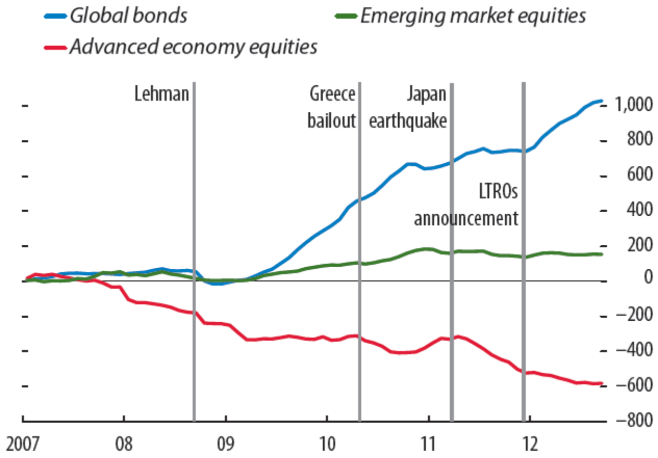
3 Primary dealers serve as trading counterparties of the Fed when QE is implemented. See the list of U.S. primary dealers here.

securities again. In other words, interest rates may never be negatively affected because QE may never be reversed.

Having said that, market forces may drive interest rates higher, once investors conclude that there is no more QE coming. This may be true, even if already implemented QE programmes are never reversed. Chart 3 illustrates the enormous shift there has been in the last 5 years away from equities into bonds in global mutual funds. This shift is at least a part result of built-up frustration with equity returns. Yield hungry baby boomers may also have played a role as their fast approaching retirement has accelerated the search for income.

Chart 3: Cumulative Flows to Global Mutual Funds (USD billion)



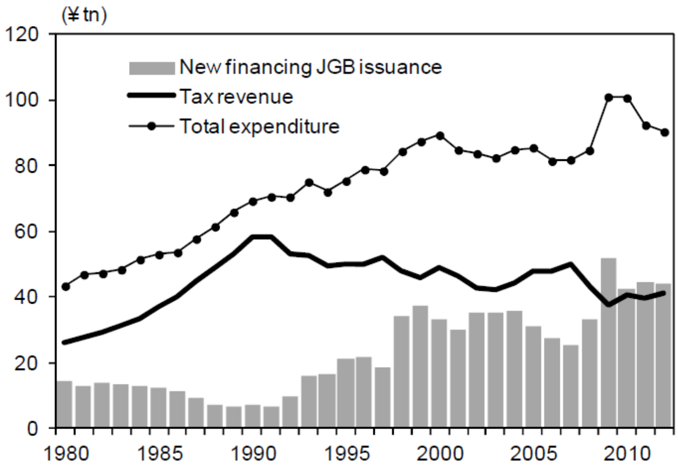
Source: IMF Global Financial Stability Report, October 2012.

However, I believe a large part of the shift is driven by what can best be described as ‘chasing returns’. In comparison to the abysmal performance delivered by many equity funds in recent years, the fact sheets produced by most bond managers look irresistible to many investors. Perhaps they need reminding that past performance is not a guide to future performance?

#3: The debt crisis spreads

The third path is what I usually refer to as the nightmare scenario. Instead of the crisis slowly abating, it actually spreads beyond the European periphery. Let’s take a look at Japan which is now more than 20 years into a seemingly never-ending recession. When the Japanese economy hit the wall around 1990, nobody expected it to fall into a 20+ year long trap of low growth, falling tax revenues and rapidly rising government debt (chart 4); however, a combination of bad policy decisions and unfavourable demographics, made worse by a strong currency, has made that happen.

Chart 4: Japan’s Fiscal Nightmare



Source: Goldman Sachs Global Economics Paper No 215, August 2012.

Following more than 20 years of dwindling tax revenues, Japan must issue more than ¥40 trillion worth of JGBs – more than a full year's tax revenues – every year to fund the enormous gap between revenues and expenditures. With the 10-year yield at 0.77% that is just about affordable. Imagine what would happen if the bond vigilantes suddenly demanded 5% in annual interest from the Japanese government.

In a way, Japan was the luckier country, being 20 years ahead of everyone else. With the implementation of appropriate policies, they could have saved their own bacon; instead they made a royal mess of it. The rest of the world is less fortunate. There are too many countries in the boat that the Japanese have had for themselves for the past couple of decades, and the boat, regrettably, is taking in plenty of water at the moment. With the eurozone members caught up in a de facto gold standard, currency depreciation is no longer an option available to them. In fact, it is not really an option to anyone anymore, as every country is keen to export its way out of this crisis. Sadly, we cannot all export at the same time. *The magic bullet has been lost.*

In countries such as the U.S. and the U.K., approximately 10% of the government's revenues are spent on interest payments on already existing debt. That is more or less where Japan was some 20 years ago. Japan should stand out to other governments as an example of how not to do crisis management. Instead our leaders seem hell bent on repeating the mistakes of Japan.

When a balance sheet is loaded with debt – whether sovereign, corporate or private – keeping the income flowing in must be priority number one. In the case of governments that translates to tax revenues. I have said it before and I'll keep saying it 'til the cows come home. Austerity kills growth. No growth, no tax revenues. Simple as that. Even the IMF has recently admitted that the so-called multiplier (which measures how much GDP you destroy by implementing $1 of government expenditure savings) is much higher than previously estimated. European governments, willingly or unwillingly, are repeating the mistakes of Japan, and the price they will pay for that will be astronomical.

#4: The crisis abates

On that upbeat note I will move swiftly to the fourth possible path – a relatively benign outcome where the crisis gradually abates, as it appears to be doing at the moment, and interest rates, as a result, normalise little by little. As a result, policy rates move up (very gradually) whereas long rates come down in the European periphery and go up elsewhere. Although this would be the best of all outcomes, it is unfortunately a scenario which is not very likely to unfold.

As recognised even by the IMF (!), the difference between the rate of interest paid on public debt and the growth rate of the economy (both measured in real terms) is *"an important driver of debt dynamics, underscoring the importance of maintaining or restoring market confidence and growth"*.[4]

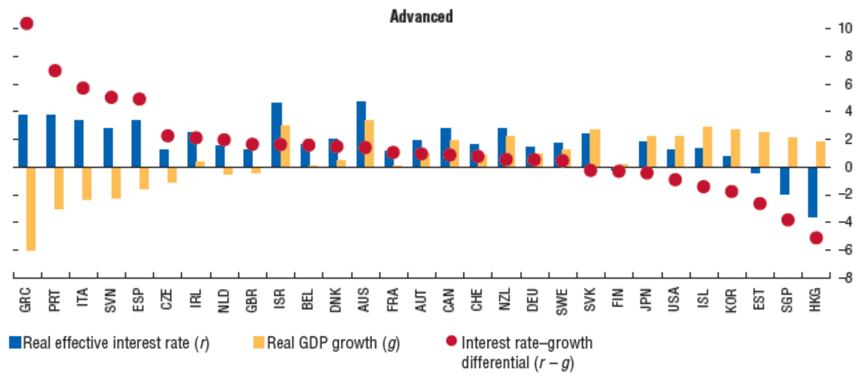
Translation: If you are loaded with debt, and real interest rates exceed the real growth rate of the economy for any meaningful period of time, you are toast! On that account, the European periphery is well and truly toast (chart 5). So, even if path number 4 is probably the most desirable outcome, it is not the most likely.

#5: Eurozone fatigue

Finally, path number 5 – also known as the eurozone fatigue syndrome. Little by little, investors turn their attention to other matters, even if the problems in the European periphery remain. Investors simply can't stand to hear and read more about Europe's problems. This is to some degree already happening. It is just too early to say whether it is a temporary or permanent shift in sentiment.

[4] *Source: IMF Fiscal Monitor, October 2012, pp 11-12.*

Chart 5: Interest Rate – Growth Differential, 2012 (%)



Source: IMF Fiscal Monitor, October 2012.

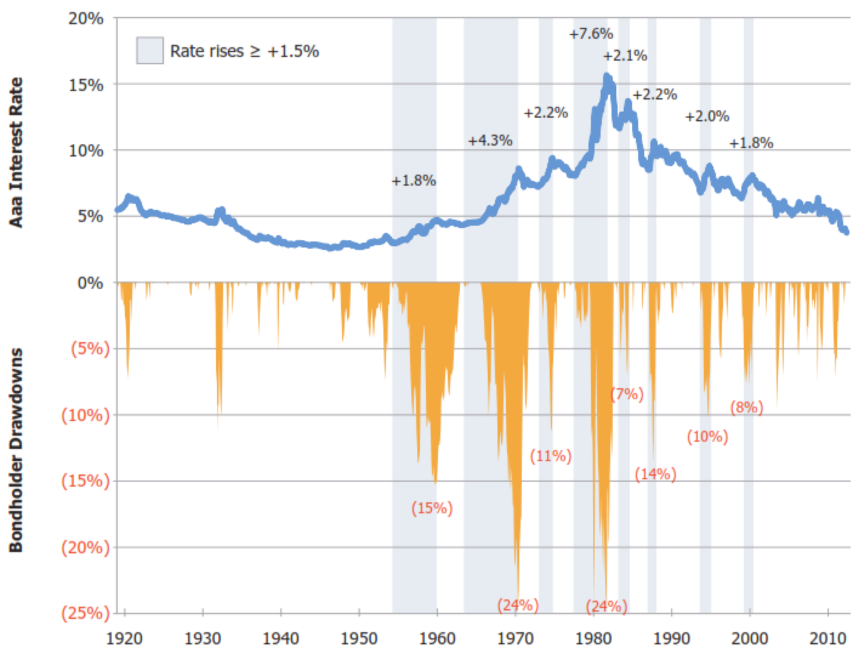
If it turns out to be of a more permanent character, cyclical factors will return to the forefront of investors' minds and central banks will become more likely to raise policy rates after five years of extremely accommodating monetary policy. If that were to happen, investors in bonds would be well advised to remember two lessons from the past:

1. When interest rates are low (as in 1954), even a modest increase in rates can have a dramatic effect on the performance of bonds. In the 1950s bear market, the yield on Aaa-rated bonds rose by 1.8% over a 69-month period. The value of those bonds was down 15% at the bottom of the cycle (chart 6).

2. When bond prices ultimately reverse, it may take a *very* long time to recover your losses. In the big bond bear market of the late 1970s and early 1980s it took five years. In the 1950s bear market it took almost nine years.

Our friends at Welton Investment Corporation have written a small masterpiece on this topic which you can find here.

Chart 6: The Biggest Drawdowns on Aaa-rated Bonds, 1919-2012



Source: "When Bonds Fall: How Risky Are Bonds if Interest Rates Rise?", Welton Investment Corporation, October 2012.

Conclusion

Now, let's see if I can put it all together. First a quick summary of the facts:

– Government de-leveraging has not yet started in earnest.
– Austerity destroys more growth than most are prepared to admit.
– The economic impact of current policy measures will thus be enormously negative.
– Only a dramatic shift in economic policy can prevent a repeat of Japan's misery.

That's approximately where we stand today. The countries on the extreme left hand side of chart 5 (Greece, Portugal, Italy, Slovenia and Spain in that order) may *never* be able to pay back their debts unless (a) there is a fundamental change in economic policy, (b) they undergo a massive debt restructuring, or (c) Germany and the other creditor nations in the eurozone continue to cough up billions (possibly trillions) of euros. For everyone's sake, let's hope that the inmates who run the asylum aim for option (a).

I am not too hopeful, though. The optimist inside me believes there is a decent probability of path # 5 - eurozone fatigue - coming to fruition. I would assign a 30% probability to that. The pessimist (realist?) fears that path # 3 - the debt crisis spreads - will prevail. I will assign a 40% probability to that outcome. The other three scenarios I all consider less likely and will only assign a 10% probability to each.

This implies that a widening of the debt crisis outside of the European periphery is our base case. Now, how markets would react to that depends on:

1. whether the problems are still contained inside the eurozone (should Japan get dragged in to the crisis, all bets are off); and
2. the economic significance of the new crisis countries; adding France to the list of crisis countries would be a great deal more serious than if it were Slovenia.

With all those caveats in mind, the implication is that, in such an environment, policy rates would stay low for much longer than anybody currently expects; however, bond yields would quite likely begin to creep higher outside of the periphery, not as a result of inflation fears but because of the change in perceived credit risk.

More generally, it would also mean that risk assets would probably continue to deliver modest returns at best. We could possibly be stuck in a low return environment for years to come. I had the pleasure of meeting Howard Marks (of Oaktree Capital) recently for the very first time. Speaking at a conference in Germany, he quoted the great, and sadly missed, Peter Bernstein who once uttered the famous words:

"The market is not an accommodating machine. It won't provide high returns just because you need them."

Never have those words made more sense.

Niels C. Jensen
6 November 2012

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