Absolute Return Partners

The Absolute Return Letter

February 2015

The End Game

"Pessimism sells. For reasons I have never understood, people like to hear that the world is going to hell, and become huffy and scornful when some idiotic optimist intrudes on their pleasure."

Professor Deirdre McCloskey

The end of cheap oil

In large parts of the financial community there is a strongly held belief that the problems which caused the credit crisis back in 2008-09 have never been properly addressed, causing many to suspect that it is only a matter of time before the 'end game' is upon us – the credit crisis Mk. II so to speak. I will in the following pages look at various ways the end game might unfold but, before I do so, I shall return to one of the subjects I discussed in the January letter – the end of cheap oil – which caused a flurry of comments and questions.

So let's begin with an update on oil. If you don't really care to hear more about it, you can go straight to page 3, where my thoughts on a possible end game begin. Let me start with a quote from last month's Absolute Return Letter, which you can find here. I wrote:

> *"All I know is that the price of oil won't stay below the production cost for a long period of time (as in years). Hence I think we will see the oil price at $100 again, and it won't take many years, but it could be an extraordinarily bumpy ride."*

Based on the number of comments I received, that statement requires some explanation. First the number itself. I obviously don't know if the price of oil will rise to $100, a little bit more or a little bit less, or over what time period. I am, however, a self-confessed numbers junkie, and want to put numbers on absolutely everything. Please do not take numbers like that too literally. Up it will go, though (I think).

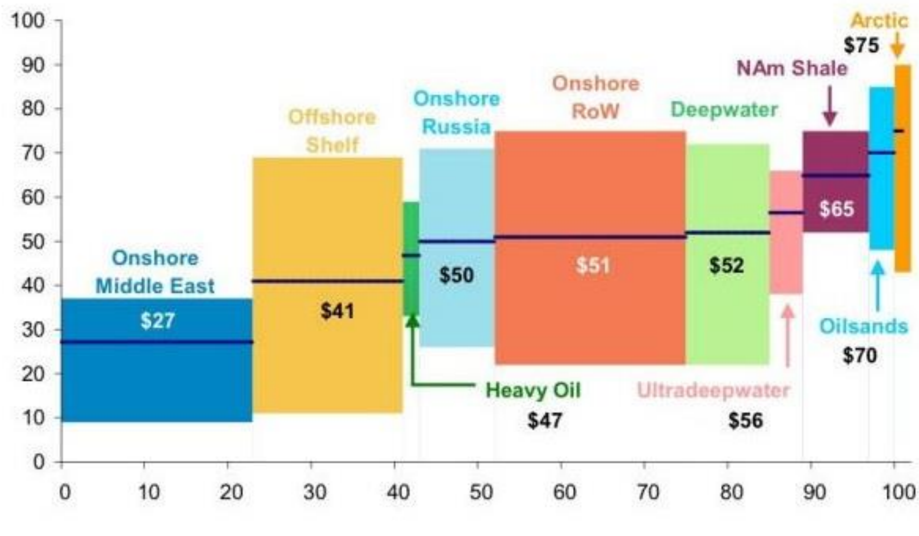
Anatole Kaletsky, who is a brilliant thinker and writer, wrote an interesting piece in mid-January which you can find here. Anatole's key argument is (and I agree) that, in a truly competitive market, the price should equal the marginal cost of production, which leads him to conclude that the current oil price of around $50 per barrel is a ceiling – not a floor. I happen to disagree with Anatole that the world is capable of delivering meaningful amounts of oil around $50.

Let me elaborate. When it comes to drilling, there are two types of costs. There is the cash cost, i.e. the cost it takes to extract oil from an already existing well, and there is the all-in production cost, which would include the cost of establishing the well, depreciations, etc. The difference can be significant to put it mildly, and longer-term strategic decisions, such as opening new wells, will, in the vast majority of cases, be a function of the oil price relative to the all-in marginal production cost. That is certainly higher than $50, but that's a story for another day.

It is not the easiest thing to calculate the exact size of these costs, as oil producing countries are not the most informative I have come across; however, Morgan Stanley has recently made a valiant effort (chart 1). As you can see, none of the newer techniques, such as horizontal drilling, Arctic drilling, Canadian tar sands and shale are cheap. And, as far as shale is concerned, the all-in production cost is particularly important, because fracking will cause the well to deplete very quickly, often within a couple of years.

It is therefore relatively safe to assume that, at current oil prices, the shale boom will fizzle out fairly quickly. The other possible outcome, which I subscribe to, is that the price of oil will rise until the true all-in marginal cost of production has been reached. What is *not* safe to assume is anything at all to do with technological improvements – particularly under times of stress – which can be very unpredictable, as time has shown. Fracking itself is probably the greatest example of this.

Chart 1: Crude all-in production costs by region

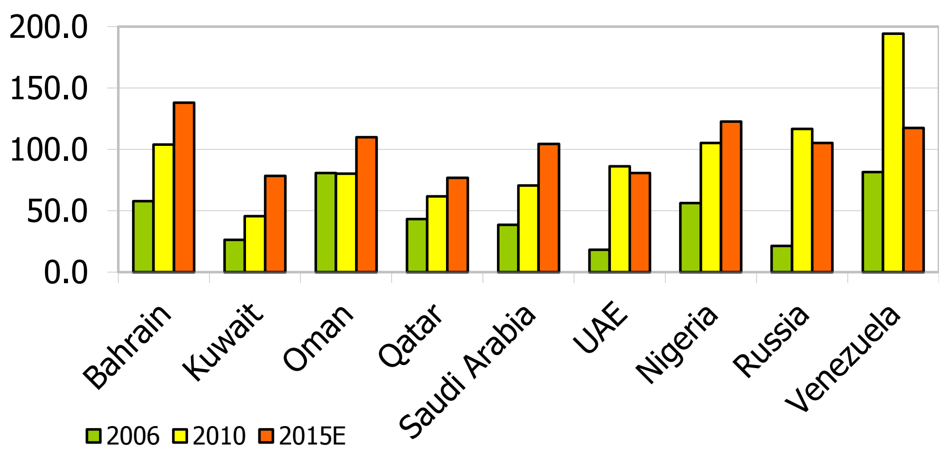


Source: Morgan Stanley, Rystad Energy, Slate.com

If I am ultimately proven wrong on the oil price, it could very well be because fracking (or a new technology we haven't even heard of yet) has effectively put a lid on the oil price, although I think the lid will prove to be a fair bit higher than the $50 suggested by Anatole Kaletsky. Should OPEC 'misbehave' and drive up prices to ridiculous levels, shale producers will simply increase production. This is likely to create a price range that is narrower, and less volatile, than the one we have experienced since the two oil crises in the 1970s, which again will be good for economic activity as it eliminates an important risk factor.

The one additional dynamic to consider is the large fiscal deficits in most oil producing countries which is only made worse the further the price of oil drops. Clearly the biggest risk factor in this context is Russia which needs an oil price of around $105 to balance its budget this year (chart 2). One can only guess if this will in any way add to geo-political instability, but it is a fact that virtually none of the world's leading oil producing countries have as easy access to bond markets as we are used to in this part of the world.

Chart 2: Fiscal break-even oil price (Brent oil in USD)



Source: Deutsche Bank, Slate.com

The end game

And now to the main topic of this month's Absolute Return Letter – the end game.

Large parts of the financial community have been on tenterhooks ever since 2008. Somehow, many feel that we have never really left the crisis environment. Central banks have, with QE, managed to 'lower the temperature'; however, the patient is still sick, or so the argument goes.

I can understand, and have some sympathy for, that view. Having said that, in my eyes, 'crisis' is a temporary condition but, after a period of time, if the condition persists, it is no longer a crisis but becomes the norm. What do I mean by that?

Since the outbreak of the credit crisis, it has been customary to blame pretty much every problem on central bankers who have become the bogeymen of modern times, at least in some people's eyes. Having said that, the critics have conveniently ignored a very important question. Could it be that the low economic growth most western countries are suffering from is due to something entirely different and has little to do with the credit crisis and/or the policies currently being pursued?

My answer to that question is a qualified 'yes', and long term readers of the Absolute Return Letter will already know what I suspect is the main reason – demographics. They have really turned against us in the last few years and won't turn favourable until the mid-2020s at the earliest, so we'd better accept that low growth is going to be with us for another 10 years or so.

Adding to that, today's central bankers have inherited a system that is to a large degree unmanageable. Europe was nowhere near ready for a currency union (at least not with that many participants), as the difference between north and south was, and still is, too great. What is an entirely appropriate policy for one part of Europe may be destructive for another part, but the diehards, who continue to blame central bankers for all misfortunes, should point their canons in a different direction.

The slightly more positive conclusion to draw from this observation is that the crisis many investors are waiting for may actually never happen. We are possibly already over the vast majority of the hurdles. We just haven't figured it out yet.

Incidents a la carte

It is not that the world is currently short of problems. Some of those can escalate and possibly turn into crisis material, but I suppose you can almost always make that observation. If you absolutely want to be negative, nothing is easier. I am sometimes accused of being overly negative in these letters, but it is part of my job to identify risks, hence the negative tilt. I have always been a believer in managing downside risk well, as the upside usually takes care of itself.

Having said that, I just don't see a repeat of 2008 on the horizon. Returns, as I have said repeatedly over the last few months, are likely to be uninspiring over the next 5-10 years but, on average, still positive. However, if the world's financial markets decide to take another tumble, here are the incidents I have identified as the most likely to kick it off:

Possible end games:

1. Deflation followed by inflation
2. Another sovereign crisis
3. Outright currency wars
4. Real-time testing of the 'new' financial system
5. Equity 'melt-up'

Deflation followed by inflation

Deflation in the Eurozone is no longer a risk but a fact. But deflation followed by inflation is not, and it is not entirely inconceivable that central bankers in both Europe and the U.S. could fall behind the curve, at least temporarily. The fear of a repeat of the Japanese disease is so deep that almost anything will be tried to get inflation going again, and it doesn't take a lot of imagination to picture an ECB or a Fed sitting on its hands (some say they already do which I don't agree with) at a time where the appropriate action would be a rate hike. I don't rate this as the most likely outcome, but neither is it the least likely to happen.

The last time a major central bank found itself falling significantly behind the curve was the Fed in 1994, and the year turned out to be an unpleasant one for fixed income and equity investors alike. You would have thought that a lesson or two would have been learned from that experience, but the real question is whether central bankers rate falling behind the deflation curve as potentially more dangerous than falling behind the inflation curve? I suspect that is the case. Remember, when debt levels are high, deflation can do a lot more damage than inflation.

Such an outcome would obviously not be very constructive for financial assets – bonds or equities - but 1994 was hardly a disaster for equity investors with the S&P 500 falling 1.5%. Even if the drop in equity values would be somewhat bigger this time around (it probably would, as there would be no support from being in the biggest bull market of all times as in 1994), a repeat of 2008-09 on these grounds is unlikely.

Another sovereign crisis

I can see a sovereign crisis developing along three different lines. The first one is Greece. Greece has just held parliamentary elections, and the left-wing party Syriza became, as predicted by many, the largest party. However it didn't quite get the 38% it required to gain absolute majority (38%? Only in Greece!), but wasted no time in allying itself with a small right-wing party to ensure a majority in parliament.

Apart from the fact that the two parties in the alliance are about as far from each other as possible (the only policy in common is the opposition to austerity), which in itself is bound to create frictions down the road, the Greek hand in the negotiations with its creditors is very weak, and much weaker than acknowledged in public by Syriza.

If serious concessions are made by the creditors, who do you think will be the first to knock on the German door tomorrow morning? Portugal, Spain or Italy? Secondly, it was no coincidence that Mrs. Merkel made a complete U-turn a few weeks ago when she said that a Greek exit would now be manageable. The Germans have prepared for this for years and are now ready (which is effectively what Mrs. Merkel said).

The most likely outcome is still a Greek recognition that the debts have to be honoured – probably with some bells and whistles attached. However, that implies that Syriza party leader Alexis Tsipras will have to eat the biggest humble pie that anyone has ever put in front of him. However, the alternative (exclusion) is so bad for Greece, that he may have no choice, even if his supporters will feel betrayed.

If the Greeks decide to renege on debts to the international community, it could create a bit of a wobble in European equity markets later this year, possibly quite soon. At stake here is the $240 billion bail-out programme which the EU, the ECB and the IMF put together for Greece. In return the lenders demanded strict austerity which has become very unpopular and is the main reason Syriza won the recent elections.

From an investor's point of view, the good news is that about 80% of all Greek government bonds are now held by the public sector, meaning that any Greek default is unlikely to do serious damage to the investment community.

Even worse than a Greek default is the rhetoric coming from Mr. Tsipras. He has said on more than one occasion that the Syriza party will take back what the rich have stolen from the poor for many years. The last time Greece made a serious attempt to confiscate large fortunes from the seriously wealthy (in the mid-1960s), it resulted in a military coup.

Germany next. Germany is obviously in a very different situation from Greece, and I am not at all predicting a Greek-like crisis unfolding in Germany. However, the fact that ECB president Mario Draghi appears willing to fall out with the Germans to get inflation going again across the Eurozone is worth spending a minute or two on.

To put it bluntly, only gold bugs and a few German professors seem unable to distinguish between QE and money thrown from helicopters. Central bankers in Europe and the U.S. have NEVER done what the Weimar Republic or Zimbabwe were guilty of, and neither are they about to.

Apart from the fact that some European countries could do with money thrown from helicopters right now, it is probably fair to say that German resentment towards QE is such that Draghi's strategy has moved Germany an inch or two closer to the exit door. The ultimate result? Most likely nothing, but it could be a very colourful next few months.

The third possible way a sovereign crisis could unfold over the next several months is if the U.S. dollar continues to strengthen. So much borrowing in USD has taken place in emerging markets over the past few years that somebody somewhere is likely to get into trouble.

On that note, I wouldn't be surprised to see the U.S. dollar taking a near term break from its relentless rise (but the USD rise isn't over yet). Recent macroeconomic data coming out of the U.S. have not been as strong as expected, and the Fed must begin to have second thoughts about raising rates as early as this summer, as they have previously said they would.

The key will be the guidance to be provided by Mrs. Yellen in the March Fed meeting, and don't be surprised if she delays the widely anticipated cycle of rate hikes. This could result in significant, but temporary, USD profit taking.

Going back to each of the three possible outcomes again, a German Eurozone exit would unquestionably be perceived as very bad news, and would therefore have a very negative impact on financial asset prices, at least in Europe, but it is very unlikely to happen. Mrs. Merkel is far too pragmatic for that ever likely to happen with her at the helm.

A Greek exit is far more plausible and would probably (after a bit of a wobble initially) be considered a positive for European equities and perhaps even for Greek equities – in particular if the exit is combined with some sort of debt forgiveness.

Why? Because a Eurozone where the members are largely on an equal footing will be considered a major positive. A critical reader or two may argue that Europe will still suffer from large (insurmountable?) problems between north and south, but the political leadership in Portugal, Spain and Italy will (a) have learned from the mistakes made by Greece, and (b) are blessed with a willingness to make the necessary changes which simply doesn't seem to exist in Greece.

A sovereign crisis in some emerging market country will probably be considered largely irrelevant for financial asset prices in our part of the world, unless it were to happen to a very large country like Brazil or Russia. The key there could very well be Petrobras and Gazprom respectively. Both corporations are large USD borrowers with earnings linked to the oil (and gas) price, so recent developments are not pleasant ones for either of them. Given the size and importance of both companies to the local economy, my guess is that what appears to be private debt is in fact public debt. We shall see.

Outright currency wars

The Swiss Franc was a wonderful currency. Stable and predictable, at least until a couple of weeks ago, when the Swiss woke up to a currency that was suddenly 30% more expensive. Even if some of those 'gains' were given up later in the day, CHF/EUR still ended up about 15% on the day. A simple decision by the Swiss National Bank to untie CHF from EUR, which was fast becoming a prohibitively expensive policy, was behind the big move.

With CHF 'out of the way', currency speculators have turned their attention to which currency to attack next, and the favourite seems to be DKK. The Danes have kept DKK within a very narrow range against EUR for a number of years, and have had to lower short-term rates in Denmark three times since the CHF incident to keep the Danish currency sufficiently unattractive to speculators.

It is not unreasonable to expect DKK to strengthen meaningfully, should the tie be loosened. The Danish media has been full of reports on how unlikely it is for the Danes to drop the link, as there is absolutely no political desire to do so and, while that is probably true, the real world works a little differently, as the Swiss found out.

In other words, a more 'coordinated' attack on DKK at some stage is quite likely. Whether the Danes will throw in the towel like the Swiss did remains to be seen, but it is nevertheless too small a currency to have the sort of impact a stronger CHF will have going forward. (I am Danish and like to think of Denmark as the centre of the Universe but, in reality, it is not).

Whatever is going to happen, there is a much bigger story here. The Eurozone at first, and then the policies pursued to address the credit crisis (mainly QE), have largely eliminated interest rates as the key policy tool for monetary authorities. In their place, exchange rates have taken over – not as dictated by the powers that be but by financial markets, at least so far.

Going into a period of relatively low economic growth, and with further interest rate cuts likely to be largely futile, it doesn't take a lot of imagination to picture the currency market becoming a playground for political leaders around the World (more than it already is). I don't know yet who will play this game the best, but expect plenty of exchange rate moves in the months and years to come.

Real-time testing of the 'new' financial system

Very much linked to the currency story above is the risk that financial markets will sooner or later test the resilience of the 'new' financial system as refurbished by central bankers around the globe in recent years, and those changes will prove to be hopelessly inadequate. The attack on CHF was in reality one such test and the strong dollar, which may still cause big problems in some borrowing nations, is another one.

Obviously, the reaction to any such test will depend on how resilient markets are. In that respect, a 30% move in CHF in less than one trading day could have created much bigger problems than it apparently did, although I have been told that we haven't heard everything yet. So, unless there are still major skeletons to come out of the cupboards, it is fair to say that the system passed this test with flying colours.

Equity 'melt-up'

While many investors sit and wait for the next equity meltdown to unfold, exactly the opposite could happen, and I am not even joking. It is not as crazy an idea as you may first think. Some of the largest pension funds in the world have recently decided to exit alternative investments almost entirely (think CalPERS and PMT). Hence the vast majority of their capital will have to be invested in either bonds or equities. With bond yields in many countries at historically low levels, the only realistic (attractive) alternative to these investors will be equities.

If you add to that the fact that more and more capital is steered towards passive investments, you potentially have an explosive cocktail, because the trend towards passive investing is likely to push valuations of the largest companies to ever higher levels. It is actually bizarre that the more expensively valued a company is, the bigger its weight in various indices will be, and the more shares investors will buy – a fact that one shouldn't ignore.

This has two implications. Firstly, as more and more capital goes passive, growth stocks will likely continue to outperform value ones (but beware; investors will wake up one day). Secondly, as the move towards passive investing drives P/E ratios of the most successful companies ever higher, we could in effect see a repeat of 1999, when valuations of certain companies were almost grotesque.

As equity prices go ever higher, investors will be happy and will conveniently ignore the fact that prices will eventually go into nosebleed territory, as most chose to do in 1999. And the more capital that goes passive, the more likely this is to happen, and the more likely it all is to end in tears.

Concluding remarks

The above mentioned scenarios are in no way mutually exclusive. It is quite possible that more than one end game will unfold in the months and years to come. For example, the recent parliamentary elections in Greece could quite feasibly end with a Greek Eurozone exit.

Simultaneously, we could have a crisis unfolding across emerging markets, as the strong U.S. dollar begins to do damage to borrowers in those countries, of which there are many. Quite how it will all pan out with both negative and positive effects is very difficult to predict.

I should also point out that nothing dramatic may happen at all. If I were a betting man, my money would be on the 'permanent condition' becoming the generally accepted view of the future economic environment. By implication that means a 'proper' end game is never very likely to unfold. One growth-slowing incident (the ageing of people in western society) has simply replaced another (the credit crisis) without too many noticing.

The implication of that is that investors will slowly come around to the fact that economic growth will stay relatively low for an extended period of time. One thing is not likely to change anytime soon, though. I expect central bankers to continue to take the blame for pretty much all miseries in this world.

Just one note to wrap up this month's Absolute Return Letter, and it is a very sad one. Ruggero Carraro, who has worked with us in Italy for several years, and who has been a great friend of the firm, has died unexpectedly at the age of only 53. The vast majority of our readership would not know Ruggero, but those who do will probably agree with me that they rarely come better than him; extremely well tuned into financial affairs and a great friend. He will be sadly missed. Ciao Ruggero.

Niels C. Jensen
2 February 2015

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