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When Money Dies

18 SEPTEMBER 2012

Fixed Income Research

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Before providing an update I wanted to refer readers to two items – which may in turn 'give away' my thoughts 'post-OMT' and 'post-QEinfinity'. First, readers may wish to reconsider a piece I wrote earlier this year in February entitled 'Bob's World: Monetary Anarchy' (20 February). Secondly – and much more interesting in my opinion – all readers are urged to read the book *When Money Dies* by Adam Fergusson.

In terms of my thoughts, I think historically important events may be unfolding. I think that by their actions both Fed Chairman Bernanke and ECB President Draghi may have belied how deeply worried they are about our economies and the financial system. In short, I see fear in their actions. But what really concerns me is that their only responses are to effectively say 'we give up', as they abandon the search for 'real' solutions to our ills. Instead, by their actions, we can now clearly see that the only solutions that are offered by the Fed and the ECB are the extension of the same failed policies that got us into our financial and economic despair in the first place. Namely MORE debt, MORE bubbles and MORE monetary debasement. When future historians look back for the day that the West lost its status as global economic superpower, and for the day that the West lost its aspirational leadership in terms of sound economic and prudent financial system management, I feel that September 2012 may be seen as a significant pivot point.

Turning to a few specifics:

1 – Politics: Both Draghi and Bernanke now seem to have deeply and irrevocably immersed themselves into the realm of politics. A review of Draghi's speech made on the evening of 6 September seems to show, in my view, that he is deeply political and is prepared to use the ECB to further his own political agenda of a federal Europe. As for Bernanke, whilst he may not be so explicit, he will surely realise that his actions are likely to impact voters in the US elections in November. History tells us that politics and central banking should never be allowed to co-mingle. The results when this has been allowed to fester have usually been very undesirable. In my view, we have crossed a critical Rubicon here. My biggest fear now in this respect is that in Europe the (mostly) elected political leadership will – when it comes to delivering fiscal union – fail to follow through, and/or the people of Europe will refuse to co-operate in the Draghi-mandated push for federalism and fiscal union. And in the US, if Bernanke's actions are perceived by Republicans to secure Obama a new four-year term, I see it as now highly likely that the fiscal cliff will become a full-on reality rather than just a thing we worry about. After all, a Republican Congress will have little to lose and lots to gain potentially by triggering a fiscal crisis IF they conclude that Bernanke has become a political servant of the Democrats.

2 – Growth and inflation: Lest we forget, neither QE, nor the LTRO, nor the OMT either have, or will, do anything sustainably positive for growth. The evidence of the last four years is clear. In fact, all I think we are likely to end up with is WEAKER growth as consumers are forced to save more and as they see their disposable real incomes fall. The idea that consumers and/or corporates will now go on a leverage and consumption/investment/spending binge is based on nothing other than hope – I actually expect the opposite to occur. The emerging world will be forced to TIGHTEN policy as the globally traded prices of food, energy and other commodities will serve to generate real and significant inflation in these nations. These higher 'headline' prices (in non-discretionary items) will – in the West – cause growth to weaken as (discretionary) demand will take the hit; Western workers have zero pricing power and aggregate employment in the West will not improve largely because QE and OMT do nothing to generate global demand. Some might feel that a weaker USD will benefit US exports. Here one should not forget that the West is and has for the last five years been in a race to zero when it comes to currency strength. USD weakness will not be tolerated for long by the rest of the world, hence any US 'gains' would be purely temporary. One major lesson of the last five years has been forgotten, or indeed rewritten. The recovery from the 2008-09 collapse was NOT primarily caused by QE1. The real drivers were TARP (real fiscal loosening) and the USD4trn fiscal and bank-financed investment binge seen in China from late 2008. I think it is crucial to remember this when the Fed in particular is 'judged' over the next few months.

3 – Credibility: Central bankers who lose credibility are a major problem. I will leave it for others to judge, but the success of central bank policy over the last four to five years when it comes to creating jobs, boosting real demand and improving Western worker competitiveness is, frankly, paper-thin. In fact, the opposite is easier to prove. I see nothing in this latest and most dangerous round of monetary anarchy that will reverse the process of deflationary debt deleveraging, other than a short-term impact on the pace of deleveraging, and whilst QE and OMT have and will boost asset prices, this is again a very short-term outcome, but possibly at a truly enormous cost. Further, specifically in terms of the Fed and QEinfinity, I am deeply worried that what Bernanke is now de facto saying is that the real underlying economic and jobs situation is much worse than we all think, that he has no idea how bad or for how long this situation will get or will last, and that as a result the only tool left is a permanently open monetary spigot. Anyone who carefully considers his actions will, I think, end up as concerned as me. Regarding the promise to keep rates lower for longer I can only conclude that either (a) this policy will succeed and so result in enormous inflation (eventually) based on the explosion in M0 and based on the Fed's 30-year track record of failing to take away the punchbowl before it's way too late, which will trigger the next collapse; or (b) the policy will not succeed (my base case). Either way, the Bernanke Fed, which helped cause the US housing bubble, then helped cause its collapse, who first told the world there was no housing bubble, who then told us that all we had a minor USD20bn-odd sub-prime problem, who went on to tell us that QE was a temporary emergency policy that would be soon reversed, and who persists in telling us that QE will help deliver millions of jobs and will bring us back to pre-crisis levels of trend growth (above 3%!) – he does after all keep telling us the problem is cyclical and not structural! – is now very much in the Last Chance Saloon. Markets and political leaders, and the US people, may well judge Bernanke in an extremely negative way over the next few months if this latest huge gambit fails.

4 – Demographics and Behaviour: These are areas which get little focus in financial markets and with policymakers, who are both generally always looking for instant gratification and doing anything to avoid the reality that money debasement solves very little in the short run and creates huge problems in the long run. But I think they matter. The demographics in the US, in Europe and in China are, at least for the next few years, very negative (i.e., rapidly ageing). Ageing populations grow slowly. They save more, they spend less, and they do not go on debt-funded consumption binges. If consumption is weak, if uncertainty is high, if fiscal policy is having to be tightened and if global central bank policy settings are already at such historically emergency settings, I find it extremely hard to understand why any CEO/CFO will feel that now is the time to lever up, to invest, to hire, or to grow. If I am right about the private sector response, then Bernanke and Draghi will have to imagine up new justifications for their actions at the very least!

The bottom line is simple: The Fed and the ECB are directing and attempting to orchestrate the grossest misallocation and mispricing of capital in the history of mankind. Their problem is that their actions have enormous unintended and even (eventually) intended consequences which serve to negate their actions in the shorter run, and which could create even bigger problems than we currently face in the near future. Kicking the can is not a viable policy for us now. The private sector knows all this, consciously and/or sub-consciously, which is why I feel these current policy settings are doomed to fail. Having said all that, the one area which for some reason still holds onto hope that Draghi and Bernanke can still perform feats of 'magic' is the financial market, which central bankers assume, rely on and are happy to encourage Pavlovian responses. The reality here though is that even financial markets are, collectively, either sensing or assigning a half-life to the 'positives' of central bank debasement policies, which to me means that even markets are only suggesting a short-term benefit from the latest policy actions. This is not what Draghi and Bernanke are hoping for, but in order for them to see the half-life outcome averted they know that we need to see major political and structural real economy reforms which somehow make Western workers competitive and hopeful again. The track record of the last four to five years inspires very little confidence that we will see such great necessary reformist strides taken anytime soon.

Notwithstanding this, in terms of markets:

1 – This Week: We are four S&P closes away from being stopped out on the bearish call outlined in my August note . It seems – let's see how this week plays out – that we were wrong to believe that central bankers would not become so 'political'. As we have captured around 300 S&P points in the sell-off that began in early April (1422 to 1275) and the rally that began in early June (1275 to 1425), and as the S&P traded at 1425 on the day my August note with its 1450 S&P stop was released, the extraordinary central bank actions of the last few weeks has resulted in a very small hit to 'our year to date'. As said, however, my stop loss will be triggered on this Friday's close if the S&P is still above 1450. So my stop-loss and I are at the mercy of the next four days' price action. Real-world risk takers/investors may choose to exercise any such stop sooner but I will wait/accept the risk. But to reiterate, if the S&P closes above 1450 on Friday, the bear call of August is closed and initially at least I'd choose to go flat/neutral on a tactical basis. If my stop-loss is NOT triggered by this Friday's close – a possibility, but not a probability – then I will write again, but my initial sense in such an event would be that the half-life upside cycle is even shorter then I currently think and has already played out. Let's see.

2 – Rest of 2012: Clearly the caveat/stop-loss above needs to be addressed first. Thereafter, I feel markets are now fully hostage to the data and in particular the political ebbing and flowing in Europe and in the US over the next few weeks and months. And for that matter in China too where, in my view, the growth slowdown seems to be accelerating, where handover to new leadership will delay until March 2013 any genuinely aggressive and detailed stimulus plans, and where the market is increasingly beginning to understand the huge risks inherent in trying to boost growth through another round of investment spending, where investment as a share of GDP will be at untenable levels (over 50%!) if all the stimulus headlines currently announced become a reality. Or alternatively, and in our base case, the market will quickly figure out that all/most of the currently announced investment plans are just that, merely plans, where little/no funding is in place and/or where funding plans are vague/non-existent, and where the market will figure out that the bulk of the announced spending plans are merely a restatement of existing plans. As such, of the USD2trn+ of plans announced, I expect only 5-10% to come to fruition on any reasonable and useful timeframe. Bottom line – in my view, and unlike in 2008-09, China capex is not going to prevent China's bumpy (at best) landing and is certainly not going to be a meaningful boost to global demand. In general I expect material data weakness globally. And as politicians have generally proven themselves to be unable to deliver the real structural changes we need, then being long risk over the next few weeks and months may feel like the right 'trade', but I do believe that the maximum upside is around 10% to equity markets (from here), and furthermore, capturing this 10% will be one of the riskiest and most stressful phases of the market rally out of the 2008-09 lows. The scope for a complete reversal in sentiment and for gapping risk-off price action is very high, so being long risk over the rest of 2012 needs to be done with extreme caution, needs to be very tactical and liquid, and will require a willingness to potentially go against the Fed and/or the ECB. Probably the most important specific items the markets will now focus on are the US fiscal cliff and debt ceiling debate, where the risks of a negative outcome are, in my view, now higher after the recent actions by Bernanke, the lack of political follow-through and worse-than-expected economic performance with respect to Greece, Spain and Italy, and in general the outlook for global growth (where the US and China will, I think, disappoint).

3 – Longer term: No change here – we continue to favour/recommend high quality non-financial corporate credit and we continue to recommend any equity exposure be focused on high-quality, big-cap blue-chip non-financial global corporates. In essence, we still favour the ‘strong balance sheet’ rule when it comes to investing (rather than trading).

Lastly, and for avoidance of any doubt, my 800 target for the S&P is truly alive and kicking. Actually, the recent Fed and ECB actions give me HIGHER confidence in this call. All that I think has really happen – at best – is that the August through November risk-off phase we forecast has been by-passed by the historic moves by the ECB and Fed, and we have now gone straight to the final leg of the 2009-2012/13 cyclical bull market, which I have talked about frequently. As set out in my previous few notes, we have long felt that we would get major QE/monetary debasement around December time, which we felt would take the S&P from 1100 (my target for the bear forecast we made most recently in August and which we thought we would see by November) up to new cycle highs out of the 2009 lows. A quick and dirty look at the charts would imply that by H1 2013 we could see mid- to high-1500s on the S&P. So as per above, if I adopt my most bullish stance possible, I can see the S&P rallying another 10% from here over the next two to six months. However, I believe that this will be the ‘riskiest’ 10% to try and capture, that this possible 10% upside move can truncate and reverse at any time, and that it will be followed by what I think will be a severe repricing of risk over the rest of 2103 and 2014, which should deliver my 800 S&P target.

Disclosure Appendix A-1

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