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Enough Blood in the Streets?

"Buy when there's blood in the streets, even if the blood is your own."

-Baron Rothschild 1871-

Our letter dated April 13, 2010 was headed, *Still Bullish*. Almost everything on world markets from stock prices, oil, other commodities, non-dollar currencies, then proceeded into a near panic sell-off while the usual safe-haven assets such as the U.S. dollar, Treasury bonds and gold rose. This was not a happy performance for most investors and those, like us who have been relatively positive on risk assets for some time (new readers can check out our views for the past 18 months on our website www.BoeckhInvestmentLetter.com which provides back issues).

So let's back up a bit and see whether our relatively positive view needs to be reconsidered. The first point is that readers of this publication and of our recently released book, "The Great Reflation" will know that we are not exactly oblivious to the deep and scary problems of the financial, economic and political world (discussed below). These continue to call for a clear focus on wealth preservation, a profound understanding of risk and return prospects and some sense of timelines and benchmarks to watch closely. So far, the key benchmarks of stability in U.S. Treasury bonds, the U.S. dollar, U.S. corporate bond spreads and low to zero price inflation are still flashing green. This means that the Federal Reserve can

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continue to pump liquidity into the banking system and economy.

The overall environment, particularly in North America, should remain positive for risk assets. We think the recent panic in financial markets has been overdone. Having said that, the economy and financial systems are fundamentally unsound and confidence is fragile, vulnerable to periodic shocks, like the recent Greek/euro crises. However, recovery from the near collapse of 2008-2009 is still underway, driven by improving balance sheets and liquidity, the exact opposite of conditions in 2007-2008 when the economy and financial systems were unravelling. Further shocks will no doubt occur and will have a significant impact on markets. The roller-coaster ride is still intact and the great reflation has added some steroids. Eventually, the piper will have to be paid, but we think that this can be put off for a while longer. But this view must be tempered with the notion that anything can go wrong at any time with little or no warning—like the euro crisis of recent weeks. Brittle confidence snaps easily and causes financial bloodshed. We think the recent sell-off qualifies, in good part, for Baron Rothschild's quip about when to buy. While this is no time for complacency, it is probably not the time to lose your nerve.

The big negatives for financial markets are well documented, as are many of the smaller ones. Frightening news sells well when people are scared and this obviously creates a feedback loop. The coverage in the press, investment research and subscription services, blogs and TV have done an excellent job of thoroughly informing us all as to the world's problems. (Where were they in 2006-2007 when the problems were being created?). There is no need to cover the same ground, so we will instead provide our own take on some of the issues. In our view, there are two key concerns that markets are pre-occupied with: one is the euro crisis and sovereign

debt dynamics, the other is the putative China bubble and potential economic downswing leading to a banking crisis, with contagion spreading of the struggling economies of the West.

(A) The Euro Crisis and Sovereign Debt Dynamics

The good news is that we have a canary in the coal mine—Greece. It's tough on the Greeks, but their painful adjustment was coming anyway. For the rest of the over-indebted countries, it has put fiscal consolidation on the front burner with a degree of urgency that comes only with a crisis. Act II of the great reflation is now upon us and it's all about slashing fiscal deficits. This is another experiment, the outcome of which is highly uncertain but clearly a huge step in the right direction. Failure to act now guarantees an eventual crisis of immense proportions.

The bad news is that the crisis in the euro area starkly exposed the profound fault lines in the structure of the single currency concept and the extent of the political dysfunctionality of the EU and euro governing process. The magnitude of the required fiscal adjustment in the highly indebted countries of Europe, including the UK has now been exposed, and it is not a pretty picture. The deflation of the bubble in the PIGS—Portugal, Ireland, Greece & Spain and some others, has highlighted the huge distortions in their economies and financial systems. This goes all the way from misallocation of labour and other resources, to a serious decline in competitiveness. There was also a temporary inflation of tax revenues but a more permanent, major inflation of government expenditures and entitlements, compounded by the recession and bailouts. Within the euro area, the primary adjustment mechanism is internal deflation. This is reminiscent of the UK in 1926, when the country went back on the gold standard with a highly

overvalued currency. Massive strikes and extreme social tensions spilled rapidly into the political arena. Sounds like Greece, Spain, Portugal and elsewhere in 2010?

Like everyone, we have been shocked at the escalating size of the bailouts from the Greece sovereign debt tragedy—$37 billion, then $135 billion, then $920 billion, the most recent. And all this for a country of 11 million people, accounting for about 2% of EU GDP! But stabilization and improvement may be in the cards now. Even though the euro is still wobbly, sovereign spreads in Europe have improved significantly. However, the most encouraging news is that the German chancellor Angela Merkel suddenly shifted from fence sitting, a relatively passive, consensus builder, to an aggressive leader, basically saying that she and Germany will "do whatever it takes." These words are magic and follow-through is very likely. If so, the crisis atmosphere will abate for the time being and give some breathing room so that fiscal consolidation will have a chance to change psychology and repair shattered confidence.

The magnitude of the fiscal adjustment required is immense. In the case of Greece, estimates are that it will be around 10% of GDP. Existing commitments of the Greek government to reduce the deficit to around 3% of GDP still leave the debt-to-GDP ratio on a steep upward trajectory toward 150% in four years. The reason is that the economy has disintegrated, while interest payments on the debts will rise. Default is inevitable; the hope is that stability can be brought to the rest of the euro area first and the fallout can be controlled.

Spain is also in serious trouble, a result of the busted real estate and construction mania. Spain is almost five times the size of Greece and accounts for 9% of the union's GDP. Unemployment is 20% and still rising; youth unemployment is 40%. Recently come to light is the tenuous state of little-known nation's savings banks called *Caja de Ahorros,* equivalent to

saving and loan institutions in the U.S. They control half of all Spanish banking assets and were the principal financiers of the real estate bubble. In total, all Spanish banks and *Cajas* have loaned close to €500 billion to real estate companies. And additionally, there are mortgage loans to individuals. The property market has crashed and real estate values continue to deflate. With this backdrop, the Spanish people and others will wonder if their government, with a big debt problem of its own, will be able to rescue its banks, if need be. So the Spanish, like the Greeks can hardly be comfortable holding deposits in their domestic banks if the crisis is not brought under control quickly.

Obviously, lots of problems remain. High growth would help tremendously but that was before, in the bubble years. This is payback time: an era of public and private deleveraging and much lower growth, at best. Reducing debt in such an environment is not easy. But, it can be done. Whether it will be done depends on the social and political fabric holding together. That is what investors must keep watching. On that score, we have to be cognizant of the historical evidence, recently pointed out by Simon Schama[1] that there is usually a significant lag between an economic shock and public disorientation, and the expression of collective rage in an organized manner. The current classic manifestation of this is the sudden rise and popularity of the Tea Party movement. It is gaining momentum and could be a major game changer in U.S. politics. Whether for better or worse, only time will tell.

[1] Simon Schama - "The World Teeters on the Brink of a New Age of Rage"
- Financial Times: May 22/23, 2010

(B) The China Worry

The China bears[2] are a hardy band of naysayers. They continue to fret about a China bubble, rising inflation leading to monetary overkill, a recession and a Chinese banking disaster. Worse, China has been one of the key engines of world growth. If it sputters out along with the EU, the rest of the world will get dragged down in another debt spiral, so the thesis goes.

With respect to the bubble, house prices began to accelerate in 2009, and some commentators have drawn the link between rapid credit growth and a looming property bubble. While some limited segments of the property market could have been considered frothy in 2009 and 2010, the reality is that the property boom is over for now. Since authorities began tightening monetary policy and implementing measures to cool the housing market, sales volume has plunged and prices have softened. The published data (Chart 1) is misleadingly subdued, showing modest year-over-year gains of only about 5%.

However, year-over-year, gains in the big cities like Shanghai and Beijing were as high as 40% at one point. Since mid-2009, the property sub-index of the Shanghai Stock Exchange (Chart 2) has declined by 46% as property developers are having difficulty rolling over bonds.

Chart 1

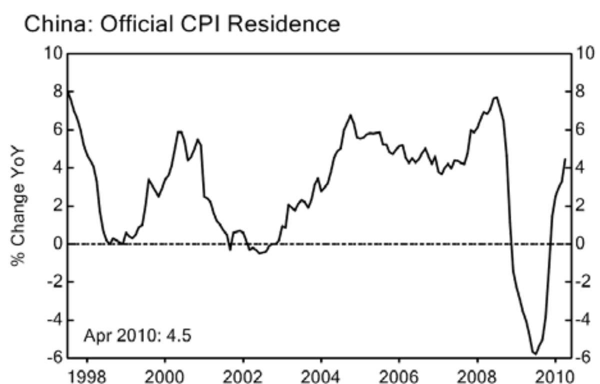


Chart 2

[2] See "China Collapse: Are the Bears are out to Lunch" Boeckh Investment letter, March 11, 2010

Some commentators fear that the Chinese property market is a train-wreck waiting to happen and that government efforts to cool lending will derail the recovery, which has been driven by an explosion in bank credit. This was a key part of the stimulus program and, no doubt billions were wasted on non-productive loans. The China bears have concluded that non-performing loans will skyrocket and the Government will not be able to use its massive dollar resources—some U.S.$ 2-2½ trillion—to bail out the banks.

A key point we want to make is that direct lending controls, such as those the government relies on, seldom work for long if not in conjunction with general quantitative controls—raising interest rates, tightening bank reserves and forcing money and credit growth down to non-inflationary, non-bubble levels.

Interest rates in China are 3.2% on 10-year bonds compared with approximately 15% per annum real growth in the economy in the eastern, developed part of the country. The incentive to borrow, spend, invest and speculate will remain huge until this anomaly is corrected. However, the authorities will be in no rush to raise rates significantly until consumer price inflation rises well above its current rate of 2.8% (Chart 3). While this level is higher than what the authorities would like, much of it comes from food and fuel prices, which are not influenced heavily by monetary policy. In a very deflationary world, the central bank is unlikely to take significant risks by tightening policy, other than cooling speculation in property.

Chart 3

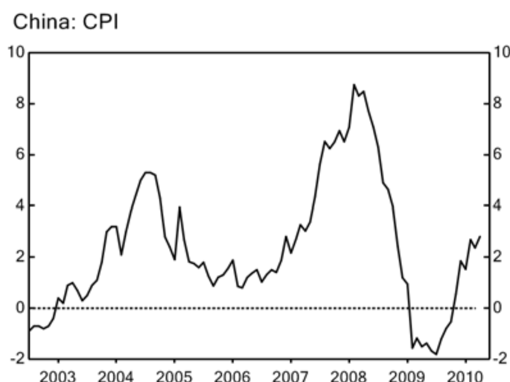
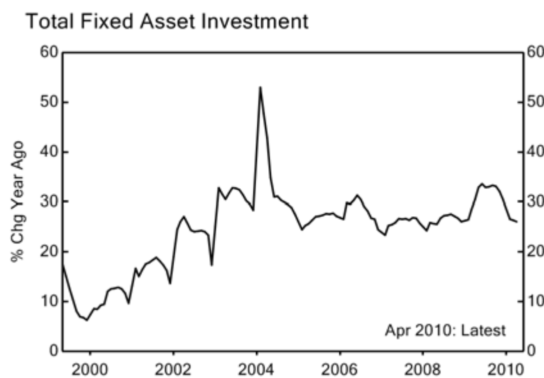


Chart 4



The second key point is that a lot of the borrowed money in China has been going into fixed investment. It is rising at close to a 26% annual rate (Chart 4) down from a recent high of almost 35%. Total investment spending in dollar terms is now significantly higher than in the U.S. Such spending ensures that the supply side of the goods economy will continue to expand at least as fast as demand, holding general inflation down. While investment spending may be a bubble phenomenon of sorts, it is nothing new in China, which is the ultimate supply side, capitalist economy. However, when it comes to regulation and monetary policy, the authorities still have a communist control mind-set. They revert all too easily to trying to direct the economy from the top rather than relying on the market, particularly market interest rates for credit allocation and market foreign exchange rates to balance supply and demand for international payments for goods, services and capital. The result is a tremendous distortion in relative prices and excess liquidity, leading to upward pressure on asset prices.

The third point is that presently, there are no signs of a widespread bubble in asset markets, with the possible exception of inventory stockpiling of some commodities. The housing market has cooled and stock prices are down 34% from the high of last summer. Therefore, we do not believe policy will become significantly restrictive, and the exchange rate

will remain seriously undervalued, as we have argued before. As a result, the economy will remain in a high growth phase, although it is clearly shifting gears to a slower—perhaps, 9-10% pace, from much higher and more dangerous rates of growth.

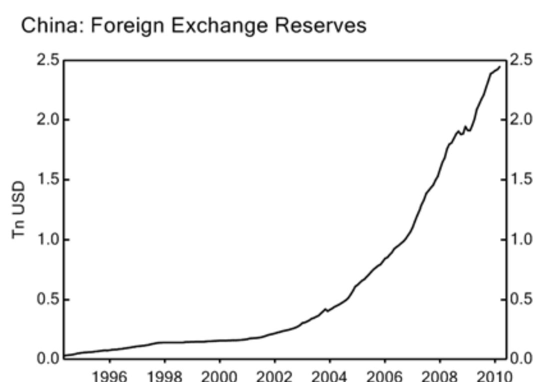
Returning to the issue of the Chinese banks, there is a fourth point to be made. Even assuming a sharp decline in the economy's growth and a dramatic rise in non-performing loans, the bear case of China being unable to use its vast dollar holdings to bail out faltering commercial banks does not hold water. That argument hangs on the need for China to have RMB not dollars to bail out banks. Dollars, of course, can always be used to buy bank shares in Hong Kong or New York.

The issue has to do with the solvency and liquidity of a country. Greece is extremely limited in its ability to bail out banks at present, not because it is short of euros per se but because it is short of dollars and other "hard" currencies, runs a huge international payments deficit, and has massive foreign debt, because the markets will not lend the Government money in any currency. This has everything to do with the fact that its public sector deficit is 13% of GDP, its government debt to GDP ratio is 120% and counting, its savings rate is very low, its GDP is falling and the Government has no credibility.

On each of these counts, China stands in stark contrast, with very low debt and budget deficits, very high growth rate and savings rate, high credibility, liquidity and a balance sheet that is the envy of the world, including US$2.5 trillion of foreign exchange reserves (Chart 5). As a result, China is in a position to borrow or print RMB on a vast scale, using its FX reserves as collateral if need be, guarantee bank capital or rely on any of a number of other options. For example, in a crisis it could take all the non-performing loans off the banks, put them in a mutual

fund and guarantee the liabilities. The point is that China is not like Greece. China has immense capacity to absorb loan losses. Unfortunately, if they go down the road of making too many bad loans and allowing bubbles to develop out of fear of letting the market work, they may eventually end up like Japan, with too much debt, excess capacity and stagnation. But China is still in a vibrant growth stage and any comparison with Japan is years away from becoming relevant.

Chart 5



Investment Conclusions

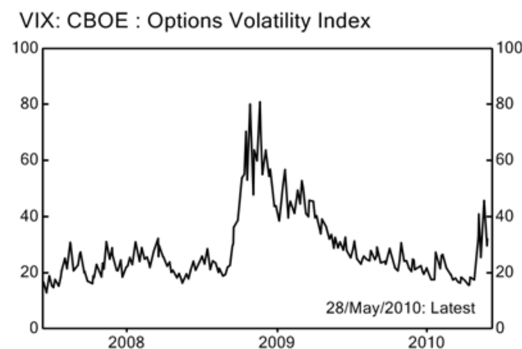
Niall Ferguson is undoubtedly right that fiscal excesses shorten the ride from imperial splendor to imperial collapse. Unresolved, fiscal excesses take countries down a one-way street to a very bad ending. However, our sense is that the road can be pretty long and there are opportunities for correction. As Adam Smith so wisely said two and half centuries ago, "There is a lot of ruin in every nation." Rome took a couple of centuries to implode, although things moved more slowly in those days.

The U.S. should never be written-off too readily. It has a lot of internal strengths. There is always a substantial adjustment restlessly moving under the surface. Clearly, the macro picture is worrying. However, the micro picture, particularly in the corporate sector, is pretty

good. Profits have rebounded dramatically along with productivity. Corporate liquidity and balance sheets are quite strong. The corporate sector prepared for a depression that never came, just as the household sector did. Credit conditions are beginning to thaw; the Federal Reserve has lots of room to maintain a policy of extreme ease because inflation is low, money supply is weak and price inflation non-existent.

Stocks are not terribly expensive. The level of fear, as measured by the VIX (volatility, see Chart 6) rose dramatically in recent weeks, an indicator of a potentially oversold market.

Chart 6



Fiscal tightening and easy money are generally bullish for stocks when the economy is recovering from trauma. We remain positive on high quality equities with good balance sheets, management and businesses.

Canada is a resource appendage of the U.S. with very strong finances and a sound banking system. Barring another global downturn, Canada should continue to do well. It has powerful long-term advantages of enormous resources in energy, food, water and metals in a world of growing shortage.

Natural gas prices look like they are headed higher, possibly quite substantially. Unlike almost all other commodities, the price rose during the recent sell-off. Gold also performed well

during the sell-off, as fear-driven financial demand skyrocketed. Gold also looks to be headed higher, even though it appears a bit like a mania. Holding some gold for insurance in a dangerous world is still valid, but it is expensive and perhaps a bit too popular. Stabilization of markets could trigger a significant drop in price and those holding it for insurance should be prepared for lots of volatility.

Commodities, in general, make us a bit nervous because so much of the recent price increase has been driven by financial demand. Should the world economy slow more than we expect, prices could correct quite sharply.

We also like emerging markets, particularly China. As discussed above, China fears are way overdone and the market has corrected 34% since last summer. The speculation in housing has been hit hard and that is a good thing, as it reduces the risk of a huge bust later in the cycle.

In summary, we are still bullish, but worried. The key benchmarks we watch—the U.S. dollar, U.S. Treasuries, corporate bond spreads and domestic price inflation—continue to flash green. Liquidity continues to improve. The economic recovery is on track and profits should remain strong. It continues to be a positive environment for stocks and corporate bond spreads. But don't take your eye off the imperative of wealth preservation.

Tony & Rob Boeckh
Date: May 31, 2010
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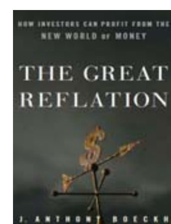

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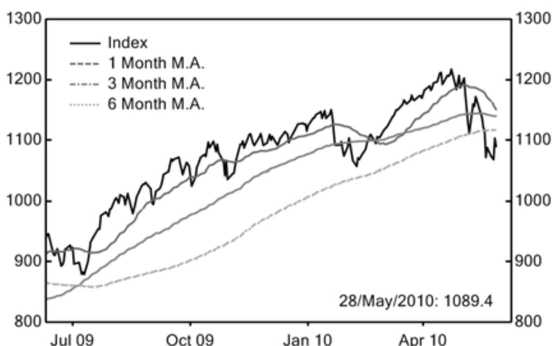
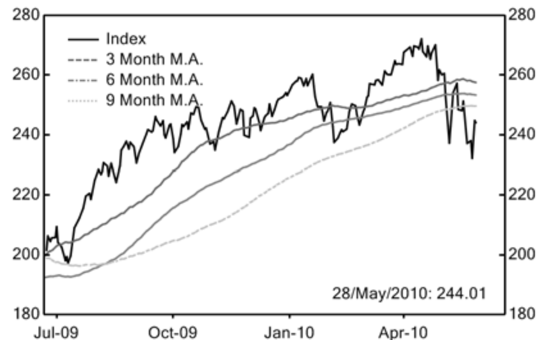
Charts: Stock Markets

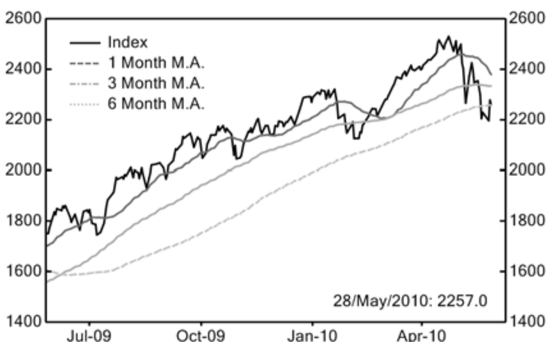
U.S. S&P 500 Composite



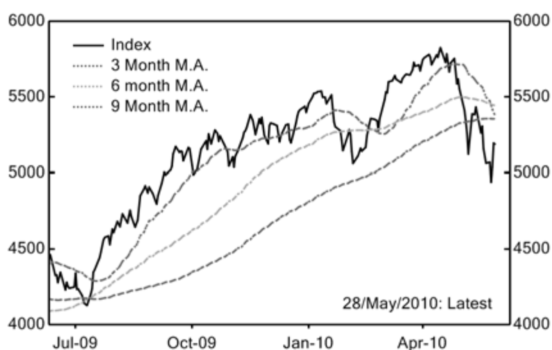
Europe DJ Stoxx 600



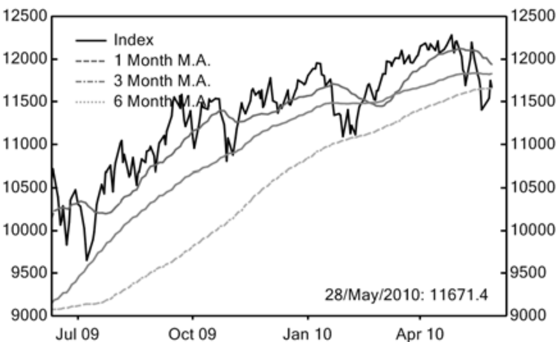
U.S: NASDAQ



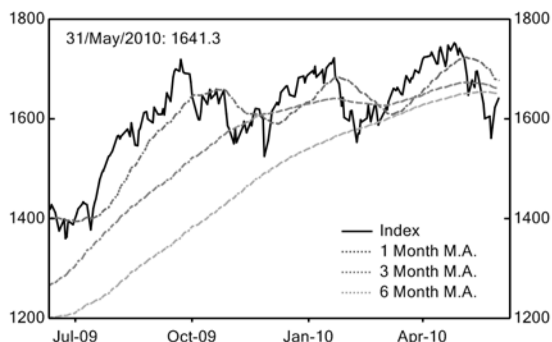
UK: FTSE 100 Cap. Index



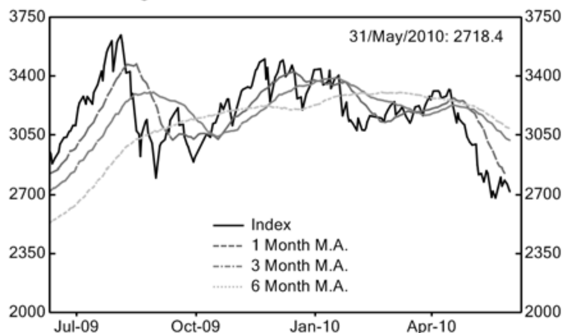
Canada S&P TSX Composite



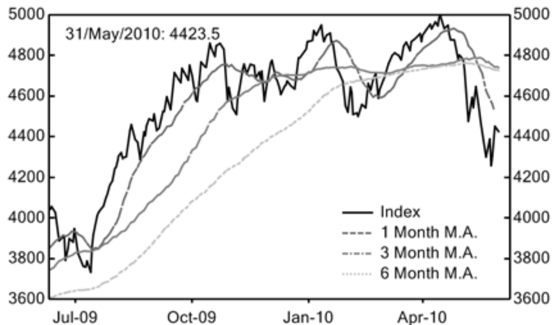
South Korea: KOSPI



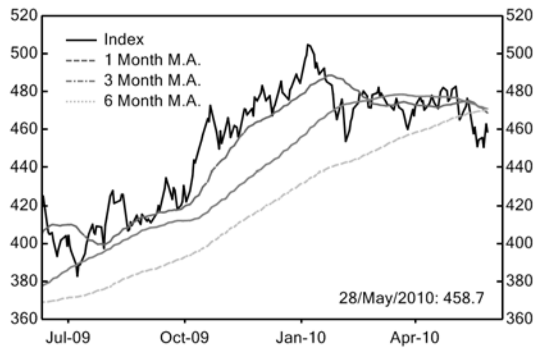
China: Shanghai A Shares

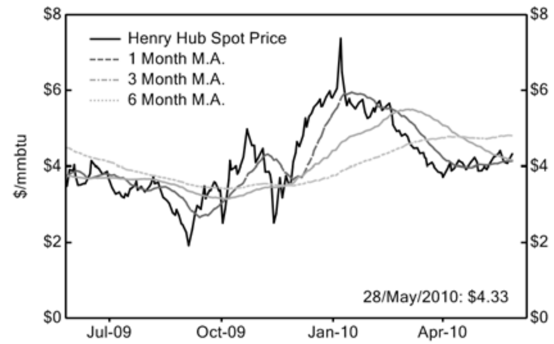


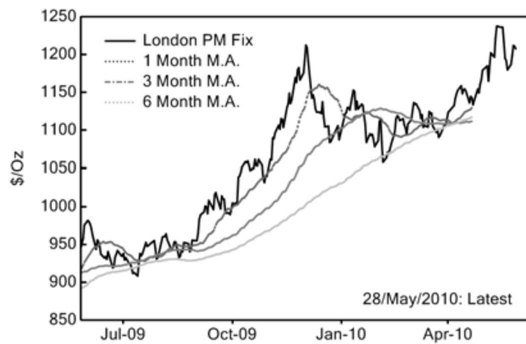
Australia: S&P/ASX 300

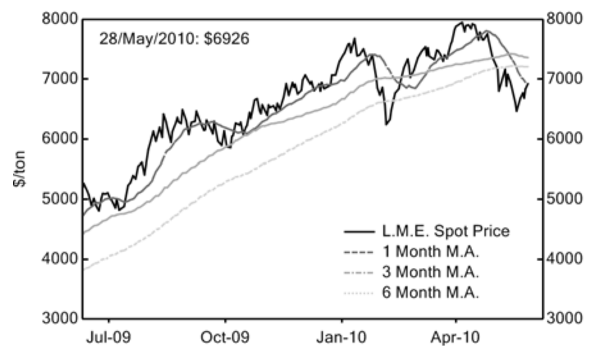


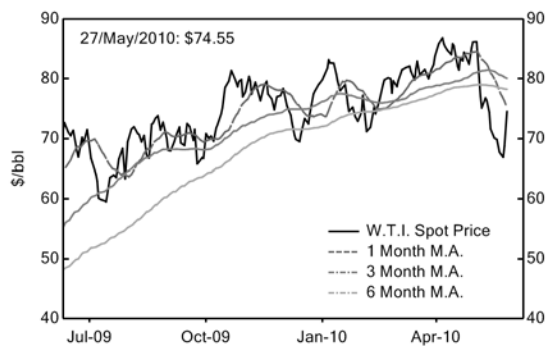
Commodities

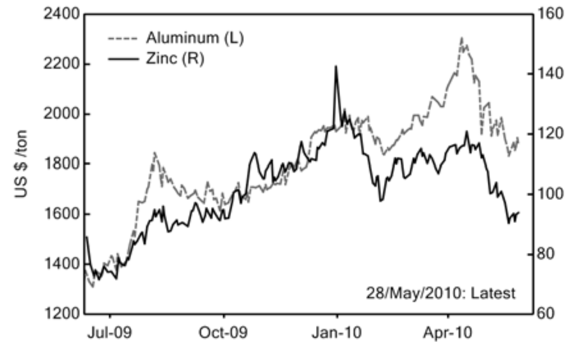




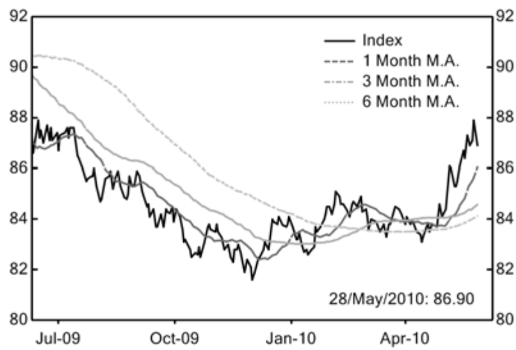


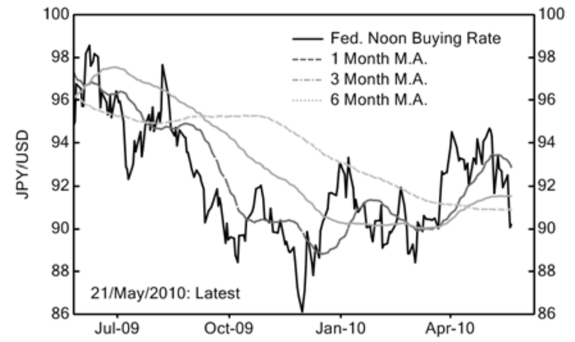


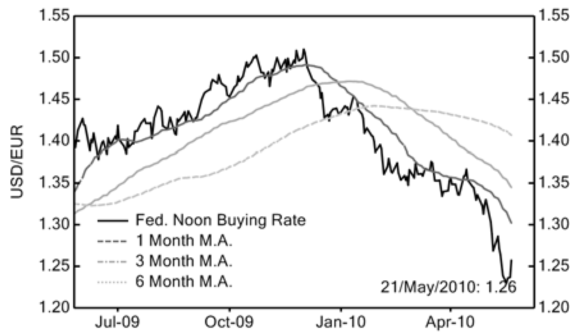


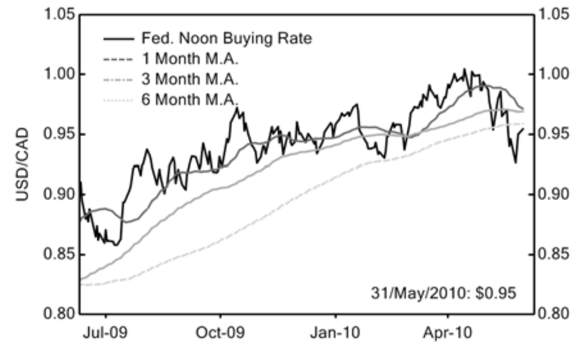


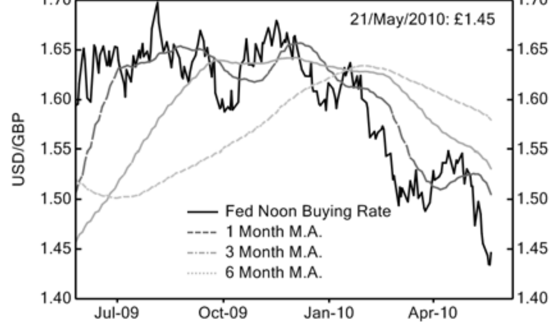
Exchange Rates

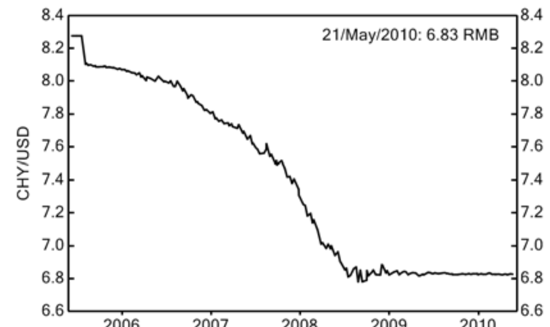




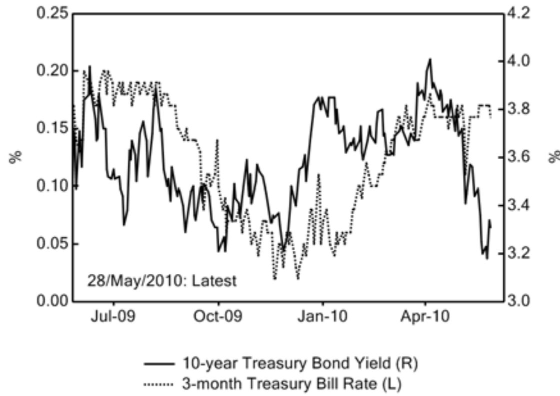


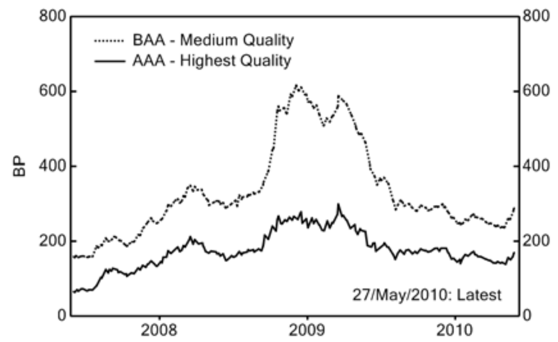


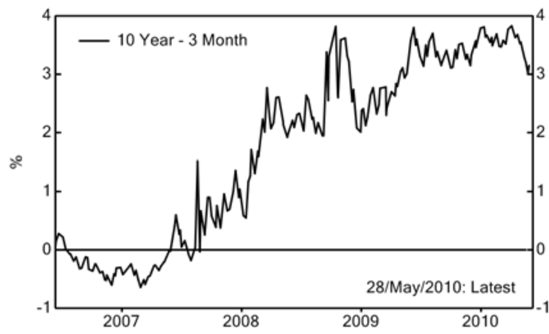


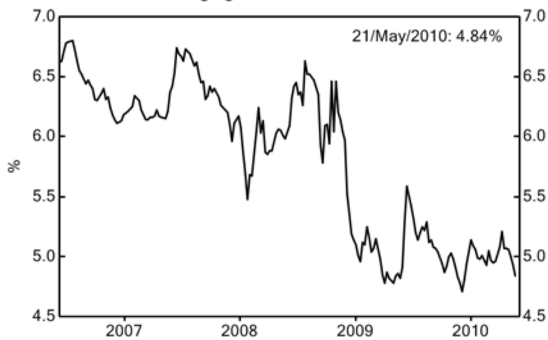


Interest Rates









Source: Federal Reserve