WALKERCRIPS
STOCKBROKERS

A PERSONAL VIEW FROM PETER BENNETT

QUARTERLY STRATEGY

Repression – alias robbery

But first: investment update

Investment

Remember, first of all, that we are living in an unprecedented set of circumstances. There is no 'road map'.

Strategy changes infrequently – though such is the ludicrous short-term performance measurement culture that 'strategists' can waltz back and forth just about overnight. New regulations (compulsory short-term performance measurement) encourage this nonsense. It does, however, give financial advisors the feeling that they have a licence to switch you around and 'sell' you with profitable frequency. I have no changes from my 'Strategy 2012' suggestions. Japan remains excellent value. Its Shiller PER is well below that of the USA. Selected medium grade UK Corporate Bonds offer reasonable value too. Ditto selected high yield quality equities – but this trade is becoming a bit too popular. China, long-term speculative bull. The shadow banking / real estate bubble is a shorter term negative. Quality fixed interest / index linked – long-term absurd. Though admittedly the short-term can last rather a long time given the dire state of the world financial system currently. Gold, hang in there with a modest position. As you know, I am a twelve year old bull (metaphorically) – but value is OK±, not 'cheap'. Emerging markets – neutral. Last year I was negative and, indeed, they behaved very badly – having been amongst the favourites of financial advisors at the beginning of the year. No surprise there.

I remain generally negative on hedge funds and private equity. In line with Warren Buffett, I feel they are, in essence, great remuneration packages for the managers.

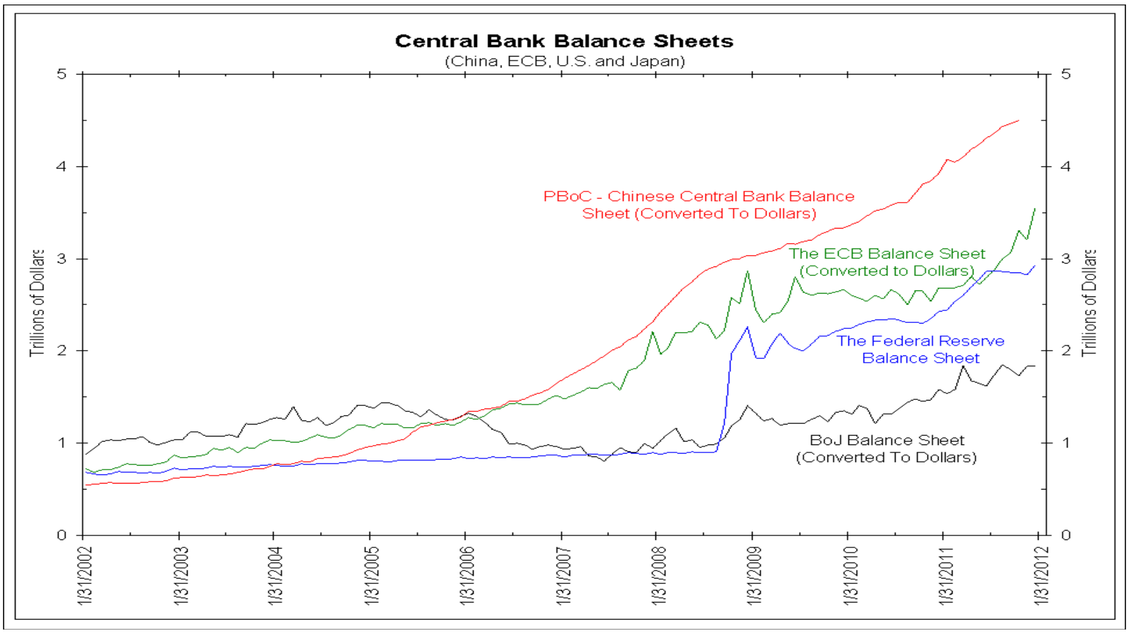
Macro

When I refer to repression I do not mean the psycho-babble word: nor Assad politics; rather, econogibber.

In plain English, it represents robbery. By manipulating financial markets in ways which would get me fined and/or struck off for 'market abuse', savers and retirees are robbed to prop up the imprudent, reckless, greedy and stupid. This is lauded by many commentators. Many, if not all, of these are themselves very comfortably off and do not take the severe hit which affects large numbers of folks with small savings. A hundred years ago (before the FED came into being) insolvents typically went bust. Dodgy debt went to money heaven. And then life went on. Living standards continued their climb. But no longer.

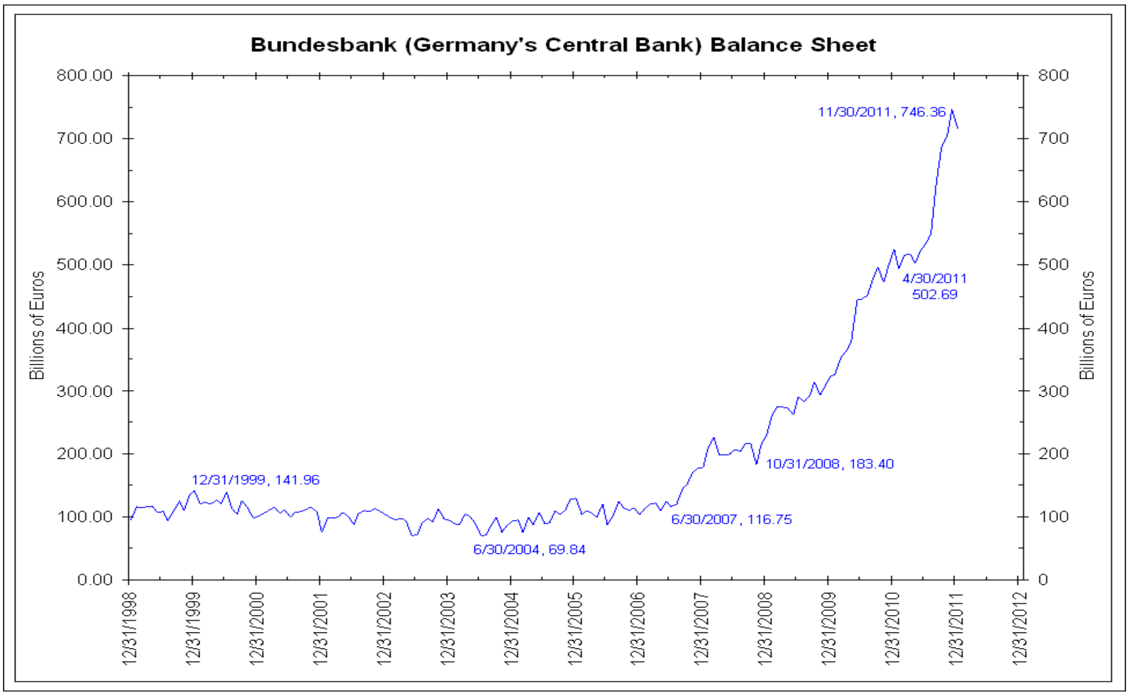
A few numbers to update you:

A graph on central bank balance sheets is shown below.



Courtesy of David Fuller.

There has never been anything like it in history. It shows the explosion in central bank balance sheets. Even the conservative Bundesbank has been dragged into this mess.



Courtesy of David Fuller

In six years, the big eight central bank balance sheets have tripled to $15 trillion. (A few more p than currently I hold in my wallet.) Take the USA. At the beginning of the 1980s when the inflation explosion was being squashed by that great chairman of the FED, Paul Volcker, the US government deficit was $197 Bn **in today's money**. Currently, $1.1 trillion. Nevertheless, debt service (interest cost) is 1% of GDP vs about 3% then. How come? Partly, this is the luck of a generation of generally falling interest rates but it also part comprises the massacre of savers. The 'interest cost' is, of course, normally their reward for saving. This is disgracefully 'repressed'.

Not only have their capital assets been decimated in value following reckless FED monetary policy combined with equally reckless 'de-regulation'. I refer to house values and investments – especially when the numbers are cost of living adjusted. OK, many of the folks were also partly to blame themselves. But the net result is the net result. Which is dire. But also the return on savings has been gerrymandered down – to bail out the dolts. Five year real yields on Government bonds (and that is before tax and any investment costs) are:

France	-0.5% pa
Germany	-1.4% pa
USA	-1.8% pa
UK	-2.3% pa

This is a gift, at gunpoint, from savers. It is like the Kulaks, forced by Stalin to hand over their farm produce, often before being done to death. Indeed, currently, those often frail and old, who live at the margin of financial survivability, may also be done to death, because they can't afford their basic bills or to heat their homes in winter. Heat or eat – but not both.

Solutions

Psychology

Kids are often afraid of the dark. It is the unknown. In daylight they can see what's what. Many highly intelligent commentators insist that the (rotten) system must be propped up for **Fear of Disaster**. (*Faux*) Keynesianism is then wheeled out as an (irrelevant) argument. In fact, Keynes never suggested more debt was the solution to mountainous debt. The spectre of the 1930's ('aargh') is hurled around, like clips from a Hollywood horror film. In fact, in the UK, having come off the gold standard in 1931 and cut government spending the economy grew well (one year over 7%), as bank rate was reduced from 6% to 2% and taxes cut, whilst public sector employees took a temporary 10% pay cut. In fact, the UK's real 'depression' took place in the early-mid 1920s. But for some reason the 1930s are routinely misrepresented. There is no *ipso facto* reason why liquidating bad debt should lead to a decade of misery. There are numerous policy levers that could be realistically pulled **after the appalling detritus of rotten money has been sent to the incinerator**. And those levers would then be more likely to be successful. As regards the US, cack-handed government policy turned a likely 1930-1932 sharp recession into a decade depression. Please may we get the facts right and leave hysteria to Hollywood.

Possibly the best proof why the prop-the-rubbish-up brigade are wrong is the sharp US 1920+ recession. Indeed, I quote the Daily Reckoning (website: http://dailyreckoning.com) "*if you throw good money after bad money you end up with no money*." and " *In the US in 1920, GDP collapsed by 6.9% in just a few months. Prices fell by 36.8% over the same period, the largest recorded fall since the end of the War of Independence in 1783. The Dow dropped by 47%. Investors panicked and businesses liquidated everything they could.*

But in 1921, roughly a year and a half after that horrific fall into the abyss, something remarkable happened. The economy suddenly, smartly bounced back. Almost as soon as the brutal depression of 1920-21 began it was over, and the roaring 20's were underway. Industrial output, prices and unemployment 'miraculously' returned to their previous level.

Right now King, Bernanke and his ilk seem determined to prop up a badly faltering financial system. But they can't keep it up".

I continue in this vein.

No situation is identical to another and, as they say, history doesn't repeat itself but it often rhymes. When overseas investors boycotted the Asians in the late 1990s Asian crisis, there was, luckily in my view, no Greenspan[2] to prevent necessary fundamental adjustments. No daft European central bank hurling, effectively 'printed', money around.

For the Asians, it was indeed a tough 18 to 24 months. But since then, system rebalanced, it became ever onwards and upwards. Indeed **they** now lend money to **us**! The poorer to the richer. You couldn't make it up.

At a smaller level, Sweden and Finland ran monster deficits at the start of the 1990's. Simultaneously there came a banking crisis. Important banks were nationalized. Shareholders? *Tant pis.* The Governments also got a grip of their finances. The currencies fell sharply and the open economies (Swedish and Finnish GDP is 35% export) picked up rapidly and the deficit problem disappeared. Yes, the world into which they were selling was growing better than it is now. But, I suspect, the general message stands. The US is only about 10% exports, but it does have a floating currency and I am puzzled that there have not been created more world class companies like Caterpillar, IBM, Intel and Macdonalds. Instead of wasting time, brains (?) and resources on the biggest (and pretty useless) gambling den in the world – Wall Street. Finance now represents 8% of US GDP. Should there be a plus or a minus in front of that 8, I ask?

Euro

Why an end to current arrangements is routinely wailed about as a likely 'catastrophe' is beyond me. The UK came out of ERM – and the result, near to heaven – Czecko-Solvakia broke their common currency. Great result. Soviet Union? Recovered and 'satellites', not too bad now. The 'opposite way' – West Germany absorbing East Germany at 1 to 1 exchange ratio was hugely painful. But, fine now. Why the knee-jerk panic? Surely, just fear of the dark.

On another tack, incidentally, if company directors are not already making contingency plans for an eventual euro break-up, their advisers need to brace up. Prepared for, I bet that the 'horror' would not be as bad as the terror 'in the darkness of the night'. The world would go on. Holding this structure together seems plain daft. I just do not see (as I have said since 1996) that there will be the democratic acceptance of the highly centralized rule making and policy making necessary to make the common currency system work. Indeed, this is THE bottom line of the whole farrago. But, of course, denial and political cowardice reign.

Jobs

Very well, isn't US unemployment coming down? The 'official' and 'household' surveys suggest net new jobs created since the bottom of the recession amount to 3M or 3.3M, respectively. Fine. But hold the front page. There are 5M 'oldies' in new jobs. So do the awkward maths. Only some net 3M+ jobs in total have been created. Oldies usually retire! What this suggests is that there are in fact worse than no net new jobs other than for those who have, effectively, been robbed of their ability to retire by decimation of their savings. Elsewhere jobs are again destroyed. Indeed, using the methodology to calculate the unemployment rate that pertained in the days of my investment youth, unemployment would show at least twice as high as it does currently.

Great policy, fellas.

Also, median real incomes from employment remain almost static – going back now to near 1970.

Some economy.

Again, hear what the Daily Reckoning has to say: "The whole system changed. Richard Nixon cut the dollar loose from gold. He may not have upset the world, but he changed the US economy. Instead of being an economy based on real money where real savings and real production increased real wages and profits, it became a smoke and mirrors economy ... with money that you couldn't trust ... GDP growth that was largely phony ... and zero real growth in wages.

From the '70s to 2012, US Stocks – measured by the Dow – rose more than 13 times. From under 1,000 to over 13,000. Here's a question: how could America's companies be so much more valuable ... when their customers hadn't gotten a penny richer?

Follow the money. From 1970 to 2007, the US money supply (M-2) grew from $624 billion to $8.2 trillion. Guess how much that is. It's 1,314 % - almost the same as the Dow."

Shadow banking

Investors will hardly be reassured by reports that I read last October in the FT to the effect that, whilst it is impossible to count accurately, shadow banking–shadow credit has exceeded its pre-crash level, despite new regulations and threats of regulations flying around like confetti. Well, regulations keep lawyers in business. Incidentally, business regulation / litigation was a few years ago estimated to be a tax on the economy similar to finance – about 8 % pa. And that's called GDP too! Again, 'positive' or 'negative'?

Going back to, say, 1850, there was little regulation and financial services represented about 0.75 % of GDP. And the economy grew like Topsy.

Re shadow banking, we still have a re-hypothecation scandal. (Ed: Wassat?) This is where collateral used for loans, e.g. from prime brokers to hedge funds, is passed round and used again and again, for yet more loans.

The IMF has estimated that, at the bubble crest, $1 trillion or so of collateral had backed some $4.5 trillion of loans. None of this was recorded in government figures, nor broker financial statements. But be thankful for modest good news. This figure is currently estimated to be down to 'only' $2 trillion. Having said which, it is now estimated that the shadow banking system was probably twice as large as was first thought to be the case. The story of MF Global (recently departed this earth, with clients' money to boot, under the leadership of a former Goldman Sachs CEO) is a fascinating story – but space does not permit me regaling you with all the details. However, to show how daft things had become in the lust for leverage, I quote a clause in MF Global's collateral contract with borrowers. No-one in their right mind would sign such a thing. But they did. Such is the power of greed.

> "7. **Consent To Loan Or Pledge**. You hereby grant us the right, in accordance with Applicable Law, to borrow, pledge, repledge, **transfer, hypothecate, rehypothecate**, loan or invest any of the collateral, including, without limitation, utilizing the collateral to purchase or sell securities pursuant to repurchase agreements [repos] or reverse repurchase agreements with any party, in each case without notice to you, and we shall have no obligation to retain a like amount of similar collateral in our possession and control."

Europe

"Canapés in Brussels. Poverty in Athens." (from a contribution to David Fuller's bulletin). You have read all about this in the papers. Or seen / heard it from other media. Once again, fear of the dark (unknown) dominates thinking. It is highly questionable that euro-exit and devaluation by one or a handful of countries is worse than what is happening to them now. The chances of the heavily indebted nations which are price non-competitive with the rest of the world paying back their debts is minimal. To have a chance of doing this they need growth. This implies devaluations. The present way of 'devaluing' is to lift unemployment so high that workers are forced to take often huge pay cuts and loss of jobs. This, of course, feeds through the economy which accelerates downwards. Devaluation by exiting the euro will also be painful. Indeed there is no way that declines in living standards can be avoided in the short-term. However, the vital difference is that having devalued, the countries have an excellent chance of growth picking up; thus breaking the circle of ever-weaker economies and ever-larger holes in national finances, until the suffering of their people really boils over.

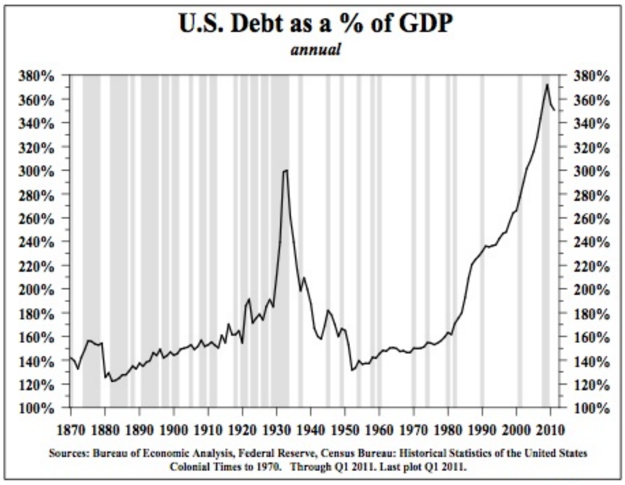
Whilst I can understand the reasons for the introduction of the euro, I always thought it was a disastrous idea (1996 pamphlet, etc). There is huge political commitment, notably by the elite, to holding the show together. Sadly it seems that the damage being done is likely already worse than a part rupture of the arrangement. Spain, for example, has near 50 % youth unemployment and 25 % overall. With things likely to continue to get worse. Can 'exit' really be worse? Only, I suggest, in the phantasmagoria of children's nightmares. Or the minds of the elitist lummoxes who will not give up their toy.

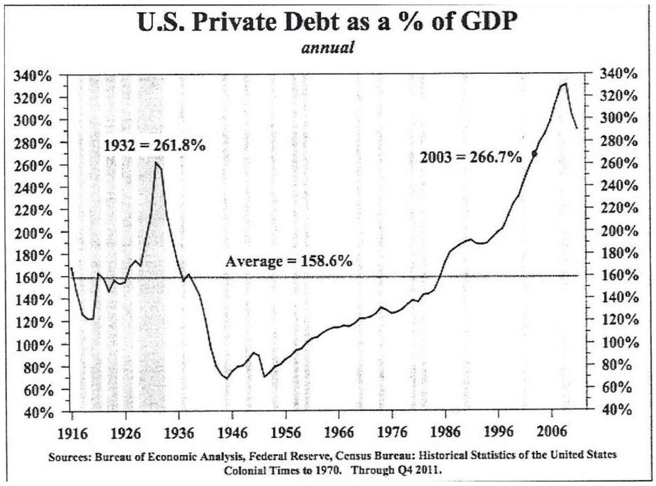
Sadly there has always been a *de haut en bas* drive behind the euro. After a superb political effort to pull Europe together (but loosely) after the war, so as to avoid yet another carnage, the euro truly represents what I suggested in my pamphlet as “a deal too far”. I suggested the spin-off would likely be growing support for extreme politics. This can be seen in the vote for Le Pen in the first round of the French election – showing at 18 % - a record for the extreme right. And in Greece’s recent elections.

Needless to say, it is still impossible to suggest how this will work out. Ditto, for that matter, the malfunctioning (despite comment to the contrary) US economy.

De-leveraging

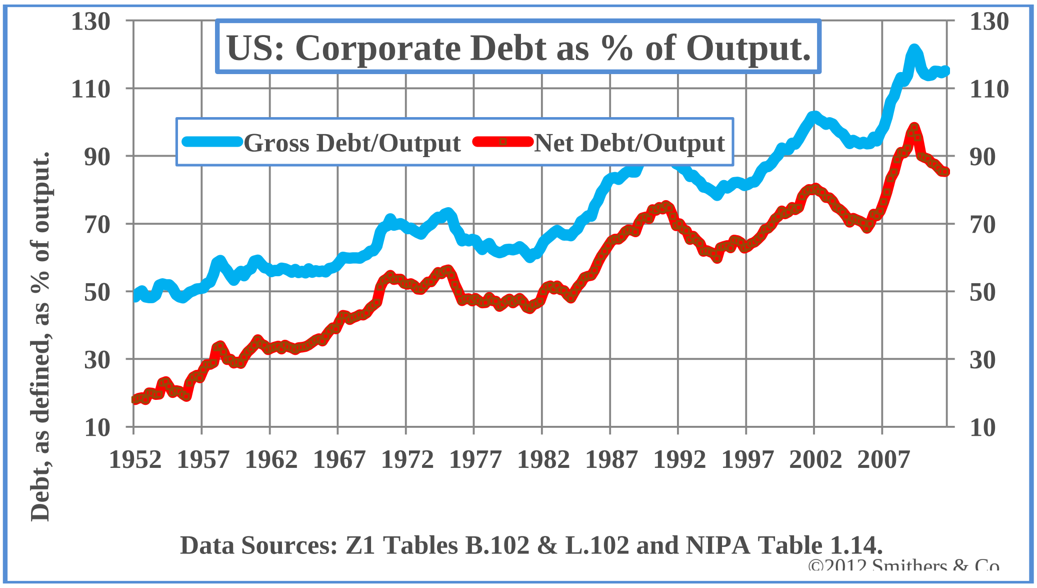
There appears to be yet another *faux* conventional wisdom. It is often suggested that the USA is well advanced in ‘de-leveraging’. Er, no. The personal sector has de-leveraged a modest amount, partly via bankruptcy. However, the government has, in essence, nationalized the credit problems of the personal sector.

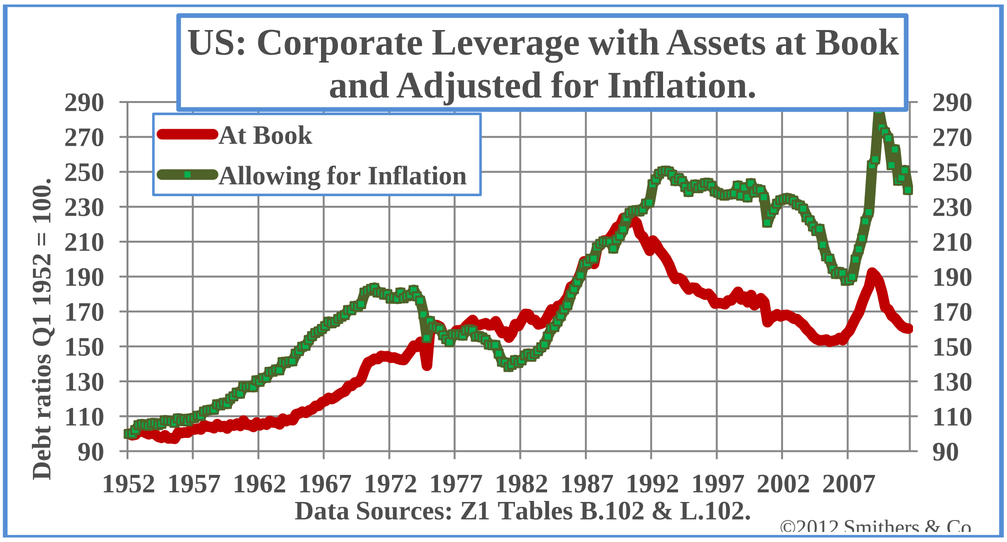




Both charts courtesy of John Mauldin (Website: www.johnmauldin.com)

The corporate sector, even including the endlessly vaunted cash mountain (much of it kept out of harm’s way overseas), is nearly as highly leveraged as it has ever been.



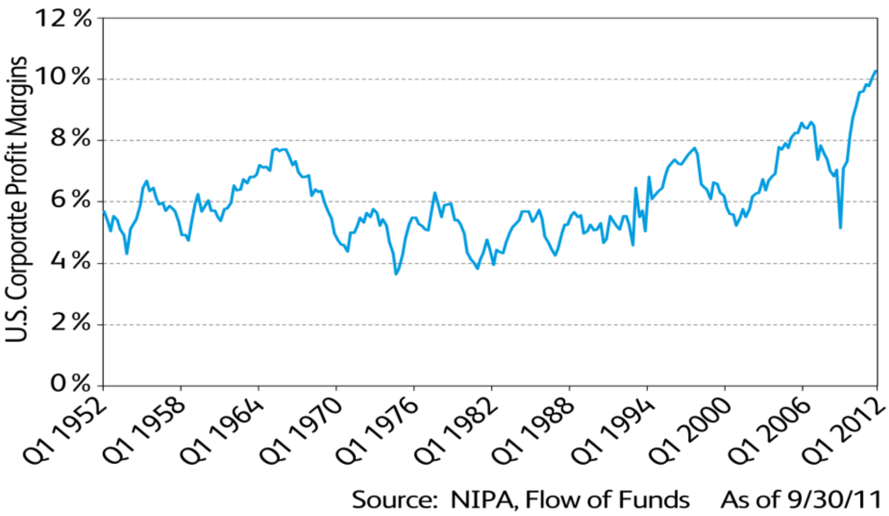


Both courtesy of Smithers & Co Ltd

Total debt to GDP is currently estimated to be about 350%. Of course no-one knows what level is sustainable. But there are a number of analysts who suggest that maybe 200% would be. Apparently that would take about 15 years at the current rate of snail-like de-leveraging. Why not think 1920 and let capitalism do its creative destruction a bit more?

Investment Conclusion

To put it mildly, we live in an unprecedentedly high risk financial environment. Surely this should be low valuation stuff, not the 50% ± over-valuation of Wall Street, as measured by the Shiller PER and Q (see also my start of year Bulletin on this matter). This figure is indeed worse than it looks as we start from record levels of profitability. Please see the graph:

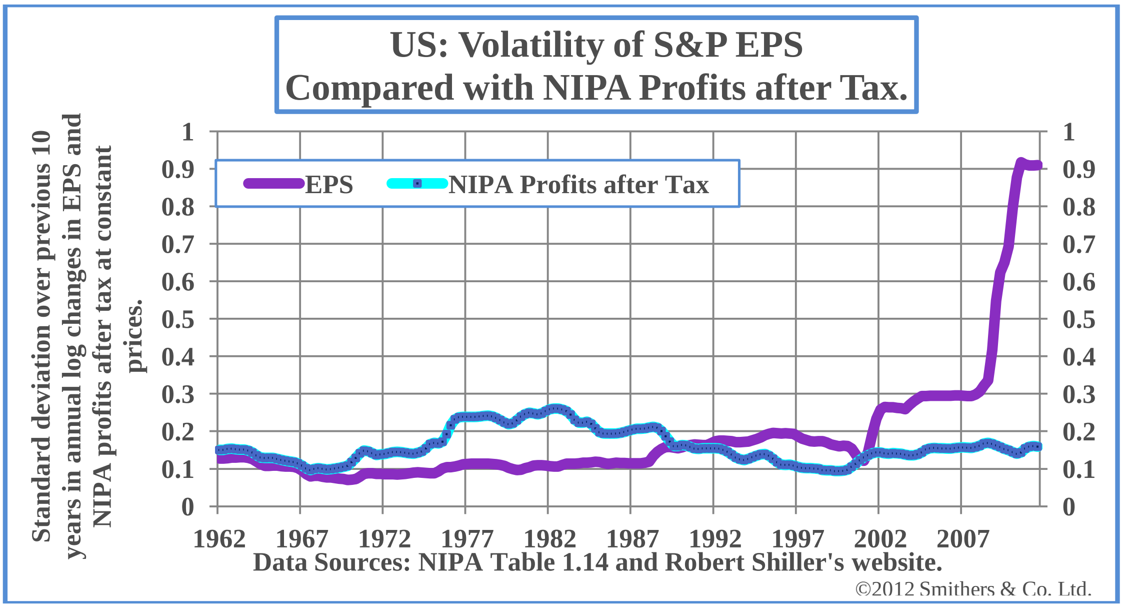


Courtesy of GMO {website: www.GMO.com}

One temporary reason for current extreme profitability is, highly simplified, as follows. In an economy one company's wages increase becomes another company's revenue, as employees spend their wages. When revenues derive substantially from borrowed money, not wages, there is barely any 'cost' to reduce profits. There has been almost no growth in real wages for a very long time.

In the end the borrowing Rake's Progress will, of course, cease.

Finally, I share a truly extraordinary graph from Smithers & Co. (NIPA profits are profits as shown by government accounts.)



Courtesy of Smithers & Co Ltd

Whether balance sheets are being used (via one-off write-offs) to absorb what should arguably be profit and loss account negatives I have no idea. Or, indeed, if other legal accounting fiddles are being used to help the 'figures'. How is it that corporate leverage is at record levels if profits are so good, whilst capital investment has barely exceeded depreciation? Indeed, profit margins are **supposedly** running 50%-70% over long term trend. It doesn't add up. Is it also surprising that for years the only identifiable buyers of equities have been corporates? Where 'insiders' (mainly directors) are selling like there's no tomorrow.

Those interested might enjoy the latest edition of the book "Financial Shenanigans. How to Detect Accounting Gimmicks and Fraud in Financial Reports" by Howard M Schilit and Jeremy Perler, which I am just getting into. Long standing readers will remember the bulletin list of monster fiddles used at the height of the tech bubble, wildly to exaggerate corporate 'performance',

Next time – an update on Japan. Which **does** represent value. But note 'value' is not a timing indicator.

Good luck.

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