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OVERNIGHT

The S&P 500 closed off by 0.18% and the Dow was off by just 0.10% today. The VIX spiked higher today after reaching multi-year lows yesterday. Correlations between stocks continues to be low. Investors are increasingly selecting individual stock and sector stories.

Cyclical sectors traded lower today with steel, homebuilders and banks underperforming today. Steel stocks traded lower on an analyst downgrade of the industry group.

Economic data was mixed as durable goods orders were better than expected with housing sales disappointing. But, even with December housing on pending home sales coming in below analyst expectations the number was up 9% over the same month last year.

Many of the largest names in technology were up today. Apple, Oracle, Microsoft, Intel and Xerox all traded higher. There were few earnings announcements in the tech sector today to explain the buying in the group.

The industrial sector traded in line with the overall market today. General Electric and Honeywell continued to be leaders in the space. Both companies have reacted favorably to recent earnings announcements. Caterpillar reacted favorably to its pre-market earnings announcement with the stock rising by 1.96%. CAT reported earnings that exceeded analyst expectations. They reported a large decrease in inventory in the quarter.

The materials sector was weaker than the overall market today. Metals and chemicals saw selling. Barron's released a negative story on iron over the weekend.

Energy traded slightly lower with crude up 0.50% and natural gas slightly lower. Energy services names were the best performing industry group in the sector. Halliburton led the area as it moved higher by 1.5%.

Consumer staple stocks outperformed the market and consumer discretionary trailed. Men's store retailers traded off lead by Joseph A. Banks trading down by over 15%. The office superstore area performed well today with Staples, Office Depot and Office Max all trading higher.

Orders for durable goods in the U.S. rose in December for an unprecedented fourth consecutive month, indicating manufacturing will keep improving in 2013.

Bookings for goods meant to last at least three years advanced 4.6%, exceeding the 2% median forecast of economists surveyed by Bloomberg, after a 0.7 percent gain in November.

Excluding transportation orders, which tend to be 'lumpy' from month to month, order increased +1.3% compared expectations of +0.4% gain and the +1.2% increase in November (revised down from +1.6%).

Non-defense capital goods orders excluding transportation, which is considered a proxy for capital spending in the economy, also increased at a better-than-expected +0.2% pace. Corporate spending had been softening lately after staying fairly strong earlier in the economic recovery, but today's durable goods report shows that it may not be that bad.

Ryland Group Inc. and PulteGroup Inc. fell at least 2.8 percent to pace losses in builders after pending-home sales declined in December for the first time since August.
The index of contracts for the purchase of previously owned homes fell 4.3 % to 101.7 after a revised 1.6 percent increase, the National Association of Realtors said. The median forecast in a Bloomberg survey projected no change in the gauge. Compared with a year earlier, sales before seasonal adjustment climbed 4.9 %.

American manufacturers from General Electric Co. to DuPont Co. are among those benefitting from a pickup in global growth that will probably keep assembly lines busy. Increasing demand for communications gear and machinery also points to gains in U.S. business spending that show company chiefs are looking beyond the federal debate on ways to trim the budget deficit.

The S&P GSCI gauge of 24 commodities gained 0.4 percent as gasoline, sugar and cattle climbed more than 1.7 percent to lead gains. Oil futures rose 56 cents to $96.44 a barrel. Natural gas tumbled 4 percent to a two-week low of $3.308 per million British thermal units amid revised forecasts for mild mid- February weather that would reduce demand for the heating fuel.

Other key economic data this week include the first read on Q4 GDP on Wednesday, which is expected to show a sub-1% growth rate due largely to temporary factors related to government spending and Sandy related disruptions.

The January non-farm payroll report coming out on Friday is expected to show job gains of about 160K, though the sharp drop in weekly initial Jobless Claims data increases the odds of a positive surprise.

We also have the FOMC meeting on Wednesday, though the only point of interest in the post-meeting statement will relate to how the central bank characterizes the current state of the economy.

The earnings calendar is extremely crowded this week, with 105 S&P 500 companies reporting Q4 results, pushing us beyond the halfway mark by the end of the week.

Total earnings for the 150 S&P 500 companies that have already reported Q4 results as of this morning are up +0.3% from the same period last year, with 63.3% of the companies beating earnings expectations with a median surprise of +2.4%.

Revenues are up +4.9%, with a much stronger 62% of companies beating top-line expectations with a median surprise of +0.6%. This is a better performance than what this same group of companies reported in the preceding quarter, but broadly in-line with the past year.

The composite Q4 earnings and revenue growth rates, where we combine the results of the 150 companies that have come out with those of the 350 still to come, is showing positive +0.3% and negative -0.6%, respectively. This means that earnings growth rate has effectively flat-lined.

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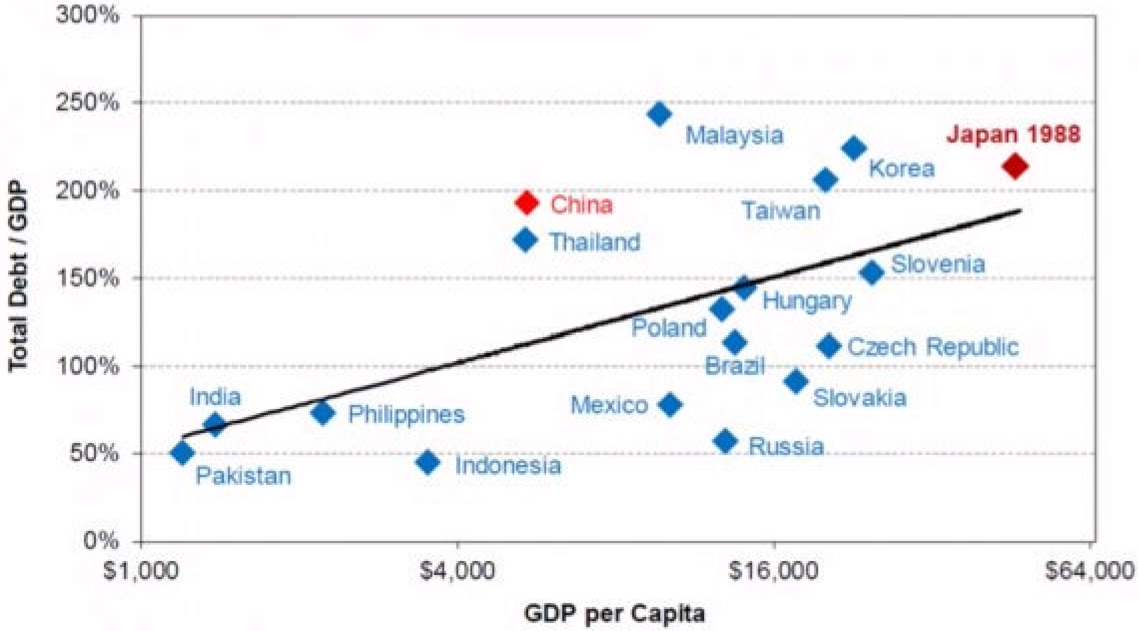
CHINA's Debt/GDP is getting negative press, which is fair enough, but also look at Thailand and Malaysia on the graph.

India ,Indonesia and Phils look fine, with still a secular growth of Debt to GDP still ahead over many years to come. (suggesting a structural long position in their BANKS)



Source: Economic Perspectives,

Maybank Kim Eng

Ray Dalio, Deleveraging, and Liquidity Bubbles

By Douglas Noland

Ray Dalio is one of the foremost economic thinkers and investors of this era. His hedge fund empire now manages $130bn. He has taken on a higher public profile of late, including notable interviews and speaking engagements this week at Davos (43rd World Economic Forum Annual Meeting). In previous CBBs, I highlighted Mr. Dalio's "beautiful deleveraging" thesis. His comments Thursday and Friday from Davos raised some eyebrows – and are certainly worthy of analytical focus.

From his January 24, 2013, CNBC TV interview:

CNBC's Andrew Ross-Sorkin: "When you talk about the economic machine, what is that, exactly?"

Ray Dalio: "So everything is a transaction, right? Every good, service or financial asset, somebody's buying, and they buy with money or they buy with credit. And so you go in to a store and you buy a suit. You buy it with money or you buy with credit. Credit is a promise to deliver money. You and I can make up credit. If I say, listen, you can have the suit and you just pay me back later, that will calculate as GDP or a sale, but yet there's no payment made. So, as a result credit grows a lot faster than money, and credit grows faster than income. And when credit grows faster than income – when debt grows faster than income - that can't go on for long. At some point, you can't service [the debt], because it's a promise to deliver money. When that money can't -- you can't come up - you have a deleveraging. So what happened in 2007 was they ran a bubble. We had credit growing much faster than money - money or income. And we had that bubble, and so now we're going through an adjustment. Let me explain that adjustment… So, in a deleveraging - and de-leveragings have happened throughout time - it just didn't happen in our lifetime before. But it happened in Japan; it happened in the '30s; happened in Latin America. They happen all the time. How do they work? Too much debt relative to income. So there are four things you can do - all of them are the same. You can either transfer wealth from the haves to the have-nots. So Germany can help Spain. You can do that or you can write down debts, because if there's too much debt you have to reduce it. So you can write it down. But the problem with writing it down - is one man's debt is another man's assets. So you write down assets, and it feeds on itself and it has a problem. It causes pain. The third way you can deal with it is that you can spend less. So, I'll borrow less: Austerity. And we go through austerity. And the fourth way you can deal with it is you can print money. So central banks can come and they can give money to Spaniards who may not be able to pay the debt, and that helps them do that. So there are always those four ways that happen. In all deleveraging they all happen. So what we've gone through, the bubble was obvious, because it couldn't extend -- you can't raise debt relative to income and the leveraging couldn't continue. And the deleveraging that was taking place had to happen in those four ways. It has largely happened…"

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"The capacity of lenders to lend, to meet the borrowing requirements, has largely been adjusted. So, Spain's borrowing has fallen. Italy's borrowing has fallen. Those types of borrowings have collapsed. With that is, of course, the collapse of their economies. That's what the depression is. You have to spend less, because you have less ability to borrow. So that causes a collapse in those economies. It was still, even with that, not enough money to service the debt. So, I use Spain as an example because it's representative. If you take Spain, but the ECB came in and put in 450 billion of money. They put in about 350bn to the Spanish banks… That was the right thing to do. The policy so far - there was a gap - an irreconcilable gap - an unbridgeable funding gap. So now what we have is a situation where the borrowing needs and the debt rollover needs and the borrowing are approximately in line, and a cushion has been created. The ECB took over - filled the gap where normally the free market does fill it, and that has now moved it along to a different condition…"

"The way I look at it is first of all, there's economics of the cause effect and so, this will be a long problem. Now I'll talk the economics and I'll talk about the markets independently, but they're connected. The economics means that there will be a long period of adjustment and what will happen most importantly is productivity. Does Europe work hard, can they do the things that are necessary to raise its living standards because it can't be on money. And there will be a social challenge, social, political challenge of ten years or so, maybe it's 15 years. Japan has made it go on for longer. The fundamental thing that they need to do most is to make sure that the nominal interest rate is at or below the nominal growth rate. I won't get technical, but otherwise what you're going to have is the debt compounding at a rate which is faster than the economy is growing. So, anyway, that picture - there was a tremendous change, but it will be a terrible economy. Because the balance is, the preventing of chaos, we came very close to having chaos right at the edge of it, because there was not a backstop. We got past that point. So now as we move forward, we can -- that can be managed, and it's going to be very difficult and very painful. As far as the markets go, now, the question in the markets is, how do events transpire relative to what's discounted…"

"Currently what we have is a lot of money is in cash. And cash is a bad thing and it's not natural that it came to be cash because the central banks printed a lot of money - so they put out a lot of cash. That's what Japan is doing, too, because it needs to do that. So it produces a lot of cash within the system. In addition, because you have the risks, people want to be safe. So they put their money in cash - and there's a lot of cash hanging around… It's a natural consequence, and what will happen is the next big moves in the markets, and the next big moves in the economy, will be based on how the cash moves. Because [cash] is a bad investment. It has a negative real return. It has a return that's substantially lower than the economy's growth rate. And at the same time, we're in a situation where risks are being reduced. So the fear, the desire, to hold that cash is reduced. You can go out on the risk spectrum, because they're reduced for the reasons we're talking about. At the same time, if you're an investor, you can start to move out of the cash, because you're missing out on returns… As that happens, I think 2013 is likely to be a transition year. Where that cash, large amounts of cash… that will start to change. It will also move. It will move to stuff. It will move to all sorts of stuff. It will move to goods, services and financial assets. So, that will include most goods, services and financial assets. People will spend more with the cash. They will -- and that will help the economy. It will move into equities. It will move into gold. It will move… out onto that curve. As that happens, what happens is, it makes the Federal Reserve's concerns begin to change. Because, by putting the cash in they've lessened the risks. As the risks have lessened and that movement starts to move then the tilt starts to change. That's probably something that won't happen immediately. This is like a classic transition year, I think. And then as you get later into the year, I think that we're going to see more of that."

Clearly, Dalio has been operating with an exceptional analytical framework. His success speaks for itself. He recognized the U.S. mortgage finance Bubble and European Bubble fragilities. He and his team have understood how global markets and economies would function throughout this extraordinary environment. And Dalio has understood policymaker doctrine, policy responses and market impacts.

As much as I respect Mr. Dalio's analytical framework, I'll continue to take exception with the general thesis that the U.S. has been moving through a successful "deleveraging" period. I have argued deleveraging is largely a myth. I contend unprecedented policy measures have only made the grand scope of a historic Bubble much more unwieldy. In Davos Friday, Mr. Dalio stated "we don't have a credit bubble" but instead a "bubble in liquidity." This is critical subject matter worthy of discussion.

I have noted that key facets of today's Global Credit Bubble are recognizable to very few. Some would argue that a Bubble doesn't exist today because Credit is not growing in excess of incomes and/or GDP. I have argued that the Bubble has evolved to become deeply systemic, in particular by inflating incomes and expenditures on a generalized basis. Hence, ratios of debt-to-income and to output won't be particularly illuminating. Actually, such ratios have become deceptive.

At the heart of today's Bubble is the confluence of ongoing massive issuance of non-productive government debt and monetary policy-induced price distortions. I have argued that this debt coupled with policymaker systemic backstops has distorted incomes, spending, and asset prices throughout the U.S. and global economy. And, importantly, this systemic reflation has sustained maladjusted economic structures and global imbalances. In simple terms, it's a Bubble primarily because of the ongoing massive issuance of mispriced Credit – an unsustainable Credit inflation that fuels global market Bubbles and deep structural economic impairment and imbalances. U.S. and Chinese Credit growth could approach $2.0 TN this year. Global hedge fund assets will set new records.

At the end of the day, my Credit Bubble framework/thesis will be proven insightful or otherwise on the issue of "economic structure." Fundamentally, contemporary economies are structured differently than in the past, and this has added layers of complexity to already challenging analysis. What counts these days as economic output? In gross domestic product (GDP), a dollar of "services" counts the same as a dollar of long-term capital investment. But when it comes to Credit, if I'm a lender I'd much rather lend to someone investing in long-term wealth creating capacity than someone borrowing to buy season tickets to the Philadelphia Eagles. From an economy standpoint, would you rather lend long-term to Germany or Spain?

Eventually, Credit system robustness or fragility will be determined not by monetary and fiscal policy (or the "reserve" status of one's currency) but by the wherewithal of the real economy. For years, chairman Greenspan trumpeted the U.S. "productivity miracle" and the incredible efficiency by which our limited amount of "capital" was invested. And each year our nation's "New Paradigm" economy consumed more than it produced, ran up huge debts, played games with risk intermediation, and watched asset prices inflate and the Credit Bubble grow to dangerous extremes.

From Mr. Dalio: "The fundamental thing that [policymakers] need to do most is to make sure that the nominal interest rate is at or below the nominal growth rate." Well, I would argue that such a policy regime may help - or it might actually make things a whole lot worse. What are the consequences of extreme policy measures? What is being incentivized – in the markets and throughout the real economy?

More specifically, are artificially low rates assisting in real economy restructuring through the financing of sound investment? Are they promoting the overall reduction in system debt - or accommodating further profligate borrowing and spending? Is the policy and market backdrop incentivizing a more favorable mix of investment versus consumption? Production vs. services? Is the manipulated cost of finance spurring greater distortions in market pricing mechanisms and further economic malinvestment?

Is the policy backdrop supporting a more robust Credit system, with financial claims increasingly backed by real economic wealth creating capacity? Or is government sector dominance only fostering greater quantities of non-productive debt and myriad distortions and imbalances? Does virtual government control over the pricing of finance have, on balance, positive or negative ramifications? Are underlying risks being effectively recognized and priced in the marketplace – or are risk perceptions dictated by government liquidity and market backstops? Are the securities markets promoting an effective allocation of resources or are the markets more akin to a "whirlwind of speculation?"

Well, these are no doubt incredibly complex and difficult concepts to contemplate – let alone gauge. Different viewpoints, frameworks, analytical perspectives and ideologies will come to radically different - often directly opposing and irreconcilable - conclusions. That is the unsettled world in which we live. But keep in mind that we're at the stage of the cycle where those that have most adroitly profited from policymaking now control Trillions of assets – while enjoying a commensurate impact on how the financial media view the world.

Mr. Dalio believes we're at some risk of a "liquidity bubble." "Money" seems to play an important role in his analytical framework. But Dalio, like many of us, ponders the question "what is money?" The role of "money" is fundamental to my analytical framework and Bubble thesis.

Contemporary "money" and Credit are essentially electronic-based. Outside of currency, what we think of as "money," Credit and "finance" are electronic debit and Credit entries in a complex global accounting system. It's essentially a comprehensive system of liabilities and corresponding assets – one person's IOU is another's financial asset; one institution's…; one government's…; and so on.

"Money" is special – always has been. It's "precious." But, importantly, contemporary money is made precious in a much different manner than had been the case historically. Money traditionally enjoyed preciousness because it was "backed" – it was a claim supported by either gold, precious metals or other forms of tangible economic wealth. Trust in money was maintained only when it was issued in limited quantities. Importantly, money is dangerous specifically because of its preciousness – faith that it won't be over-issued and conspicuously debased. To a point, demand for money is almost insatiable. And too many times throughout history the government printing press has been used as a political expedient.

There is today seemingly little that differentiates "money" from Credit. They're all just electronic entries. Contemporary "money" is Credit – but it's special Credit. It's special because of the perception that it's a safe and liquid store of nominal purchasing power. It's precious these days specifically because of the perception that policymakers – especially central bankers – will ensure that it maintains its essentially "risk free" attributes. It has indeed enjoyed insatiable demand – and this has allowed Trillions of "money" to be issued in the post-2008 crisis environment. And this "money" inflation has been absolutely instrumental in sustaining the global Credit expansion – in the process reflating markets, economies and animal spirits. It has again proved invaluable as an "expedient."

Dalio is calling 2013 a "transition year" and a "game changer." I'm sticking with my "Bubble Year." From Dalio: "There's a lot of money in a place that's getting a very bad return and in this particular year there's going to be, in my opinion, a shift. The complexion of the world will change as that money goes from cash into other things. The landscape will change particularly later in the year and beyond."

I'm OK with "liquidity Bubble" terminology - and I'd be alright with "money Bubble." The key to the analysis is to recognize it remains an unprecedented monetary Bubble – an integral facet to sustaining a global Credit Bubble. I agree with Dalio that a flight out of this "money" holds the potential for an extraordinary 2013. I just wish I could be as sanguine. I worry about what this "money" might do. But my greater fear is that global policymakers have impaired the creditworthiness of "money" – the foundation of global finance. They fell for the same monetary inflation trap that has cursed humanity throughout history.

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Unprecedented "money printing" has continued for too many years. The debits and Credit add to the Trillions. Along the way, the Fed has tried to assure that they do indeed have an exit strategy. I have all along the way argued there would be No Exit. The Fed has theorized how they would withdraw liquidity before it could fuel higher inflation. From a global Bubble perspective, I've seen the greater risks in asset inflation and rejuvenated market Bubbles.

The Fed and global central bankers have essentially been in the business of creating Trillions of market-based liquidity. When they're content to sit patiently in "cash" accounts, all these debits and Credits are seductively benign. Inevitably, however, they're also a tinderbox. After all, it is the nature of return-seeking market-based liquidity to chase the inflating asset market ("liquidity loves inflation"). And if enormous amounts of trend-following and performance-chasing "money" flow into already speculative and increasingly dislocated financial markets, well, some will rejoice a new secular bull market.

The Fed, of course, would never admit it has fomented another major Bubble. They will, once again, see inflating asset prices as confirmation of the success of their policymaking regime. The (highly unstable) rate of market price inflation will continue to play a backseat to the (relatively stable) high rate of unemployment. But you'd think they'd begin questioning the necessity of their $85bn monthly "money printing" in an environment where it is increasingly obvious that there's way too many Trillions of "money" looking to chase too few global risk assets.

The Fed would be well served to go immediately back its drawing board and try to figure out how to stop all this liquidity from turning inflated and highly speculative global risk markets into a completely out of control mania. I'm not holding my breath.