

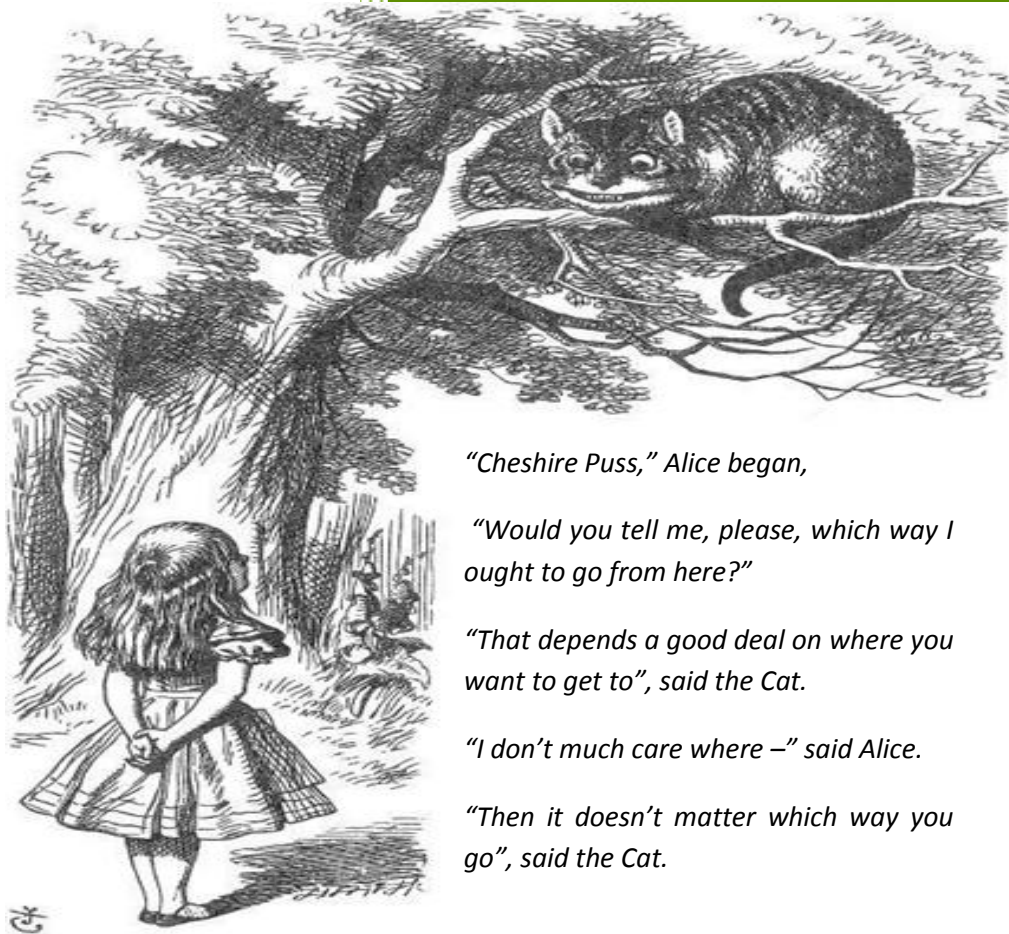


calamander capital

alternative investments in the world's fastest growing markets

# 2009

## The Cheshire Cat



*"Cheshire Puss," Alice began,*

*"Would you tell me, please, which way I ought to go from here?"*

*"That depends a good deal on where you want to get to", said the Cat.*

*"I don't much care where –" said Alice.*

*"Then it doesn't matter which way you go", said the Cat.*

### **Roman Scott**

*Managing Director  
Calamander Capital*

*Economic Spokesman  
British Chamber of Commerce Singapore*

Issue XI  
25 November 2009

Q4 2009 Economic Briefing  
British Chamber of Commerce Singapore

Calamander Capital  
London and Singapore, 25 Nov 2009

## The Cheshire Cat

I have just returned from a short trip to London, which coincided with the time I had to prepare my year end *'Economic Briefing'*. This seemed apt, having ended the April 2009 Q1 Briefing with a gloomy prognosis for the UK economy. Several months of increasingly poor economic data since then had only reinforced my conviction Britain was in trouble, and recovery a long way off. I confess I expected widespread signs of economic distress-shuttered shops, 'sale' signs on every corner, empty restaurants and un-crowded streets; under grey skies and Britain's perpetual winter drizzle. The perfect backdrop to write my brand of gloomy economics, with a mug of Tetley tea and The Smiths playing in the background.

The reality was shocking. Everything appeared exactly as I left it on my prior visit in August 2008, before the collapse of Lehman. The Tube was still jammed with people from all corners of the world, Regent Street was thronged with shoppers, and it was business as usual at every office we visited. My sister treated me to the theatre-it was packed. 'I thought there is a recession on?' I said to the maitre d' when a meeting at Claridges turned into a long wait for a table at the lobby café. 'Not at Claridges' was his sniffy reply.

I felt like I had accidentally hopped into the 'Back to the Future' DeLorean. London appeared more concerned about a phenomenon dubbed 'Jedward', seventeen year old twins who had made it into the finals of a reality TV talent contest called the X-factor, the British 'American Idol'. The twins couldn't sing, couldn't dance, and sported a ridiculous hairstyle that looked as if they had just received a 5,000 volt shock, and yet somehow they kept on going regardless. A perfect proxy for the UK economy.



**Figure 1:** 'Jedward': Recession chic in Britain.

Source: *Mirror.co.uk*

### Markets versus Economics

So much for the 'The Great Recession'. And therein lies the paradox. The global economy has been through the biggest contraction in economic and trade activity, asset prices, and banking system credit worthiness for seventy years. Normal market mechanisms vital to the proper functioning of the banking system that are trust and confidence based, such as interbank lending and short term credit markets, completely froze. Only prompt and massive central bank intervention prevented the potential catastrophic collapse of the financial system in the West. Yet if you had just arrived today on earth and landed in London, or Singapore, you would not have guessed anything was amiss.

Anyone who has forgotten just how close we came to economic Armageddon were reminded last week by the stunning admission by the Bank of England that The Royal Bank of Scotland and HBOS, two of Britain's largest banks, had come so close to collapse the BOE had extended over 60 billion pounds of emergency liquidity in a covert 'lender of last resort' operation last October, and kept it secret until now. Most economic forecasters saw a long and difficult recovery given the extent of the contraction and the fact that banking systemic crises invariably lead to deeper and longer recessions, a position I have argued repeatedly in previous *briefings*.

That is not what the asset markets have been saying. Since April all major stock indices have smashed records, well beyond the expected recession recovery bounce. Some market strategists have announced

the being of a new bull market cycle. And, perversely, every other asset class from the ultra conservative (US treasuries) to the risky (emerging market equities, commodities, gold, art) have joined in the frenzied recovery.

How does this relate to my views in the *Q1 Briefing*? Like many, I have been surprised by the markets. Although I stated that investors were right to be more confident at the time, I remained cautious about investing, and I did not forecast the speed or the strength in recovery of asset prices. Post summer I have been firmly bearish, waiting for a correction that never seems to happen.

I had good news and bad news in the *Q1 Briefing*. Good that depression had been averted and recovery seemed assured; bad that this recovery would be a long slow haul and most 'green shoots' looked vulnerable. Was this correct? The gist of my argument was that the extent of policy action (both fiscal and monetary) and its co-ordination globally was unprecedented, and would work given its size relative to GDP combined with aggressive monetary easing. It would however leave a damaging legacy by replacing private demand with debt driven public stimulus. Demand contraction in the G3 would continue for some time; recovery was in corporate profitability and not in more important consumption; US consumers were saving not spending; global recovery would require first and foremost the US to stabilize and grow again; China or Asia would not 'save the world' as export dependency still underpinned most BRIC economies; the damage from unemployment would continue; global trade remained sick; and the cleanup of the banking system was only half complete, restricting the normal flow of credit mature economies require. Not exactly a picture of robust health at that time.

Unfortunately I believe the majority of economic data from the G-7 (rich) countries year to date continues to support this position. So what explains the extraordinary rise in asset prices? Is this performance based on firm economic foundations and set to continue, or are the bears correct and the risks to the downside?

## The Real Economy

**Core economic indicators:** Although the US and major EU economies have returned to positive growth (Q3 q-o-q for the US 2.8%, EU 0.2%, Germany 0.3%, France 0.3%), it's a case of crawling not walking. Consumption and retail sales remain muted (October retail sales +1.4% in the US and -0.2% in the EU for September), with a backdrop of appalling levels of unemployment-over 10% in the US and close to that in the EU. The US figures have been flattered by stimulus measures including cash rebates and the 'cash for clunkers' boost to auto sales. Consumer confidence remains negative in the G2, severely so in the EU.

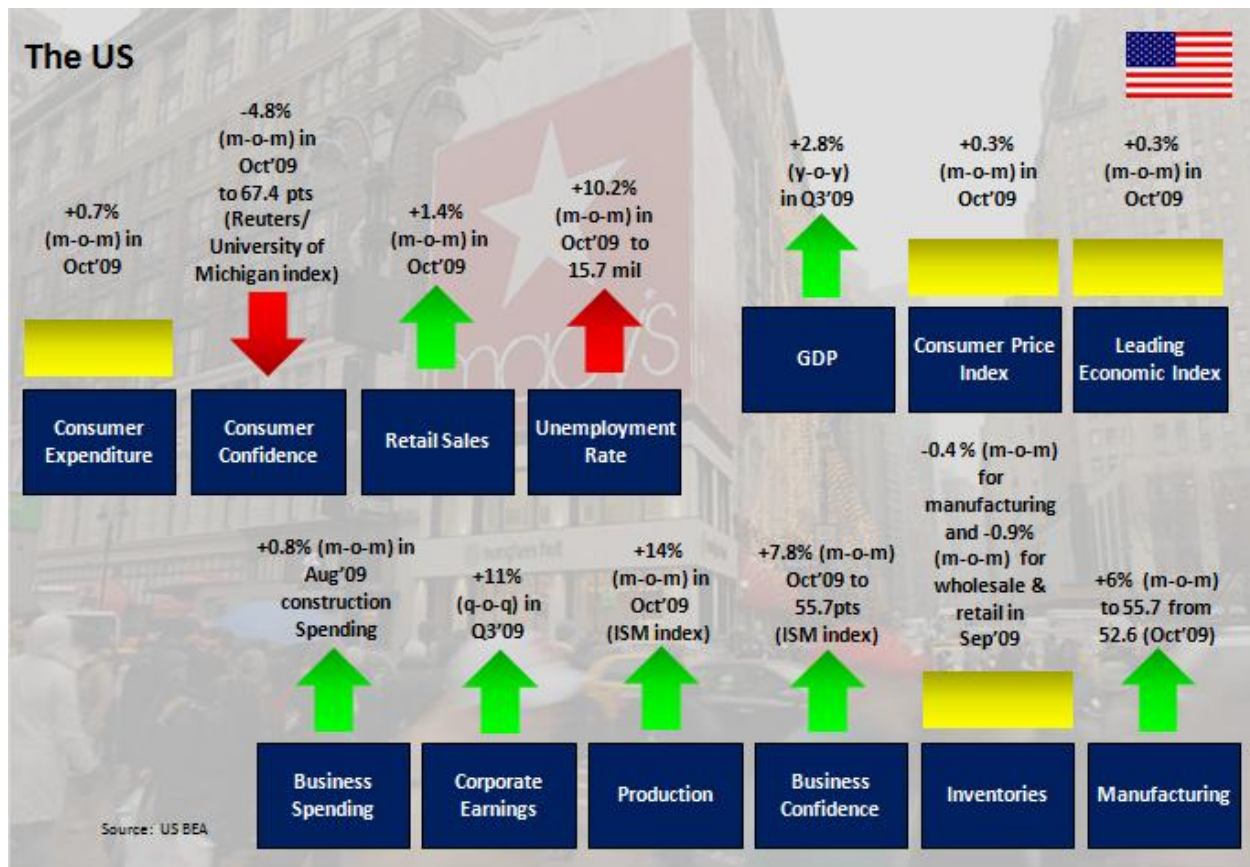


Figure II: US economy core indicators.

**Housing**, one of my key US indicators because the housing related economic ‘eco-system’ accounts for about 30% of GDP, remains in the doghouse. A brief summer recovery died in the autumn. Housing starts are back to 45,000 a month, compared to my long run average measure (from 1963) of 129,000. I cannot find any silver lining in that very dark cloud. Worse, signs of **deflation** appeared in the US in September for consumer prices (-0.2%). Both the US and the EU are only just keeping their heads above water for consumer prices (US: +0.3%, EU: +0.2% in October). Trade and industrial activity is only now starting to recover in the EU (manufacturing +2.8% September m-o-m), and in the US (+6.0% October m-o-m), after a very poor summer. The EU data appears worse, partly because it entered the recession later, and because corporate earnings have not been boosted by severe cost cutting as in the US.

Finally, for all the low interest rates, **bank credit** is still contracting in the US and the EU G2 economies. The pile of toxic collateralized mortgage paper remains on bank’s balance sheets, impairing the extension of new credit. Bankers remain cautious, a well established post financial crisis reaction, as credit officers regain power over salesman and want to ensure they don’t make mistakes.

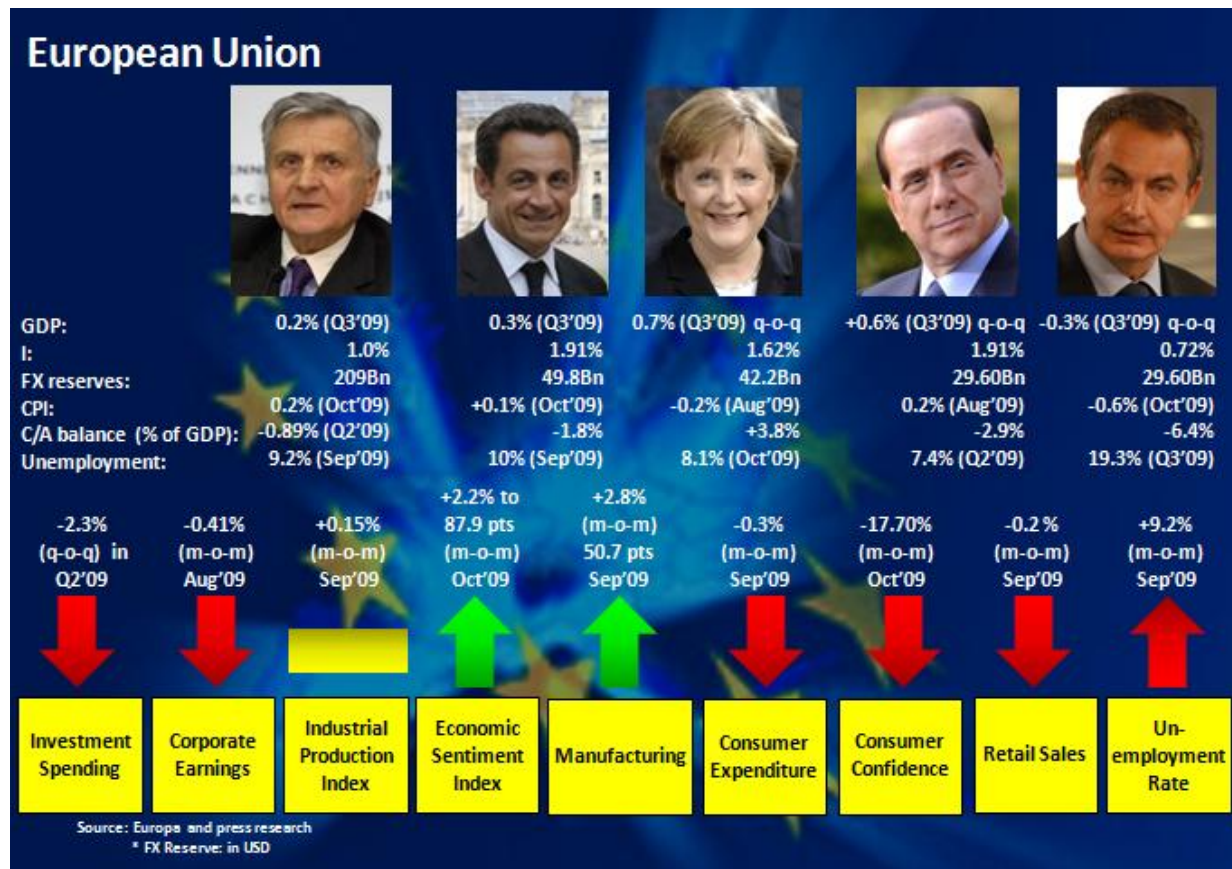


Figure III: EU economy core indicators.

**Retail sales:** My view remains unchanged that real global recovery requires US consumption to return. Even more so for us in Asia-I still think Asian 'decoupling' is nonsense at this stage, a reality for 2030 mistakenly applied to today. US corporations can, and have, flattered the earnings reports this season by comparison with a very low base as the year view moves into October 2008's collapse, and are seeing the benefits of severe cost cutting. But corporate profits are not the key driver for a developed consumer economy, they simply make stockholders happy. It is overall consumption, retail sales and employment that are the real drivers of recovery. Retail shops, and their sales figures, are the frontline of the battle. Here there is some way to go (see Figure IV-V below).

# US key retailers' revenues 1999 - 2009


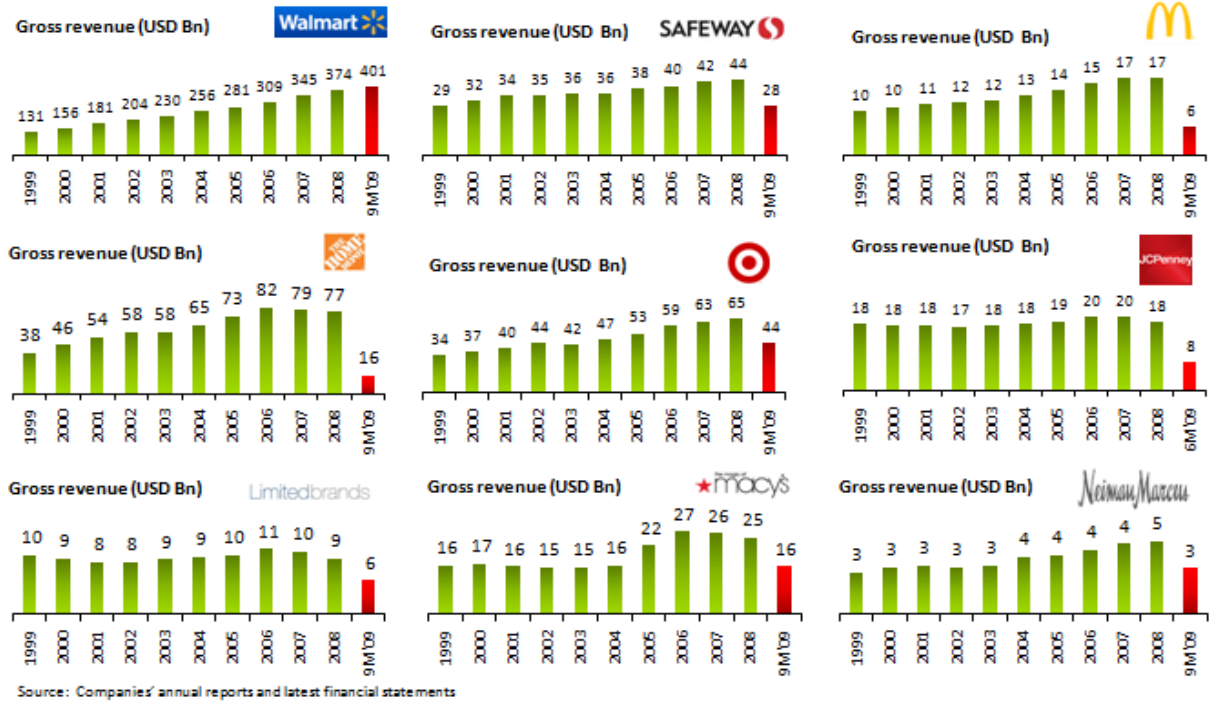



Figure IV: US key retailer's revenues 1999 - 2009.

The majority of the US stalwarts-Home Depot, Macy's, Safeway, JC Penney, Neiman Marcus, and Target- are only now seeing sales stabilize after twelve month declines averaging over 20% (with a range from -6% to -80%). The same applies to my European sample. As expected, home related stuff has plummeted (The US's Home Depot). Luxury discretionary purchases have been hit hard, represented in our data by the EU's LVMH (luxury clothes, watches and liquor) and the US's Limited Brands (lingerie, beauty products, accessories with Victoria's Secret, Bath & Body Works, and LaSenza). Only Wal-Mart has done well and, in Europe, IKEA. Cheap wins when times are hard, although surprisingly MacDonal'd's has not, and expensive M&S in the UK has held up.

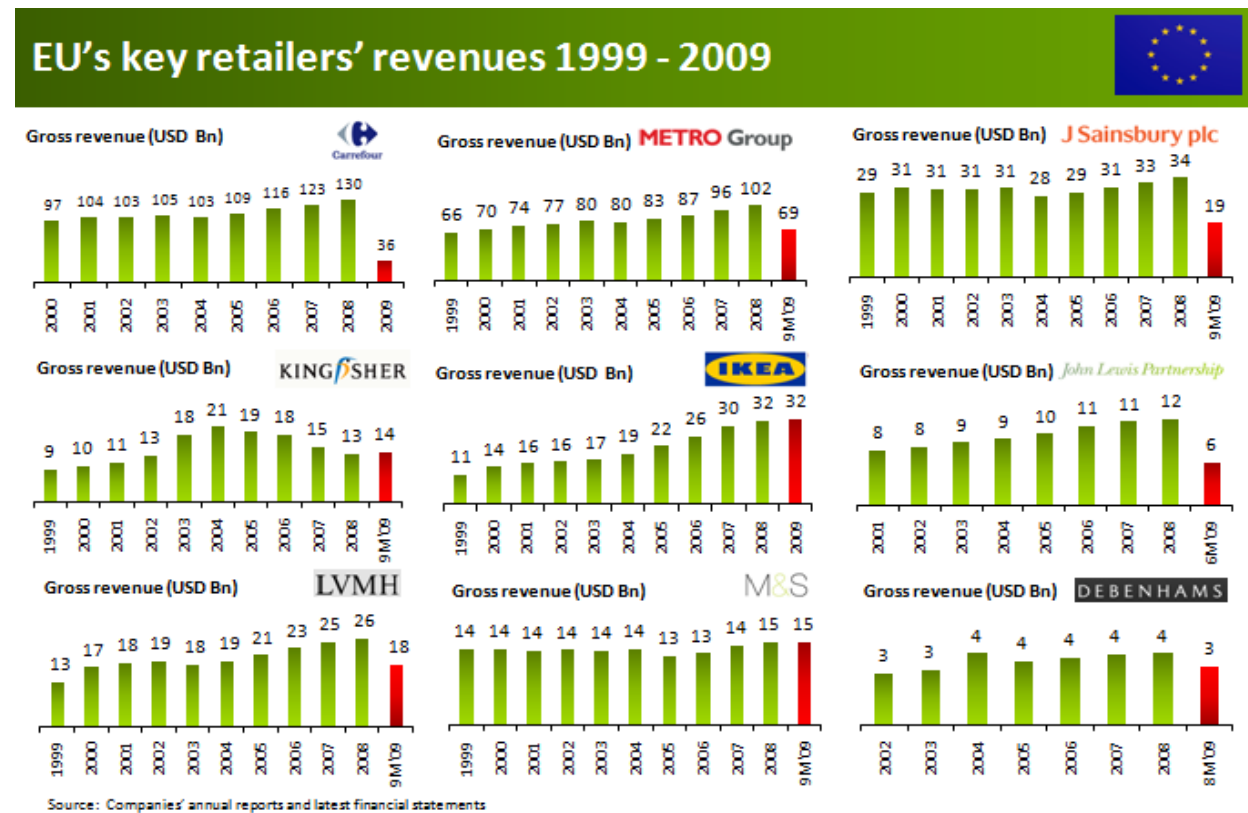


Figure V: EU key retailers revenues 1999 - 2009.

Poor consumption contrasts with the positive noises coming out on the economy as a whole. This is the 'wealth effect' kicking in-a sense of caution and a reduction in economic activity by consumers because their reference point for the value of their household balance sheet is the value of their home. This has declined markedly in the US and in house price bubble markets in the EU (UK, Spain, Ireland etc). Add in employment concerns and wallets stay closed. The return of high oil prices also helps ensure that recovery will remain muted. Energy prices act like a tax for consumers, so the brief collapse in prices early in the year functioned like a cash return for crisis stricken households that almost matched the government's stimulus. That is now gone forever. So despite consumers hearing that the recovery has started, they feel they are poorer and are more insecure. Perhaps G2 consumers, like the Japanese for the past two decades, sense that their future liabilities (in the form of government debt) have risen also.

**Household debt:** US and some EU household debt levels remain high, and consumers are deleveraging. At debt levels of 129% of post tax household income for the US they have to. The UK continues to hold the shocking record of 163% for the same. As consumers spend less, they are saving more to rebuild their balance sheets. Savings levels jumped up to over 5% in the US, are now down to 4.7%, but show all indications that Americans are starting to save again. They need a minimum of savings level of 5-7% going forward to restore health.

**Autos:** My other favourite measure for G3 consumption is auto sales. It is the ultimate consumer high end spend, desirable but discretionary for replacements. A five year old vehicle can always be run for several more years. Headline data again has been misleading here. Monthly auto sales are a closely watched indicator and I believe the market gets lost in the latest month on month (m-o-m). The big picture is lost. Hence all the positive noises about the demand boost from Government stimulus via the 'cash for clunkers' scheme applied in the US, UK, Germany and other G7 countries. Summer autos sales in the US climbed from the sub 10 million level (annualized) they had been at in the first half to 14 million units, feeling like the good old days. The market recognized that a relapse was likely, and indeed US sales have returned to just over 10 million.

But it would be wrong to think the 14 million units of stimulated demand was a good result. The long run trend data gives a stable US market trend range of 17 million (range 17.0-17.8) units per year for a decade, up to 2006. The first time this dipped below 17 million units was in 2007 (16.5 million). What this means is that the US auto industry is likely built for an 18-20 million capacity. If 14 million was the best a major stimulus could do, that's disappointing. If 10 million cars is the new normal for the US, it means an industry at 50% of capacity, a disaster. Let's say the industry recovers to 12-13 million, that's still at 60-65% capacity and no end to the misery than has already virtually bankrupted Chrysler and General Motors. Carlos Ghosn (CEO of Renault/Nissan) summed up the auto industry prospects perfectly answering a question on the prospects of a 'double-dip' recession: *"I don't believe in a double dip because we didn't come up"* in the first place. Quite.

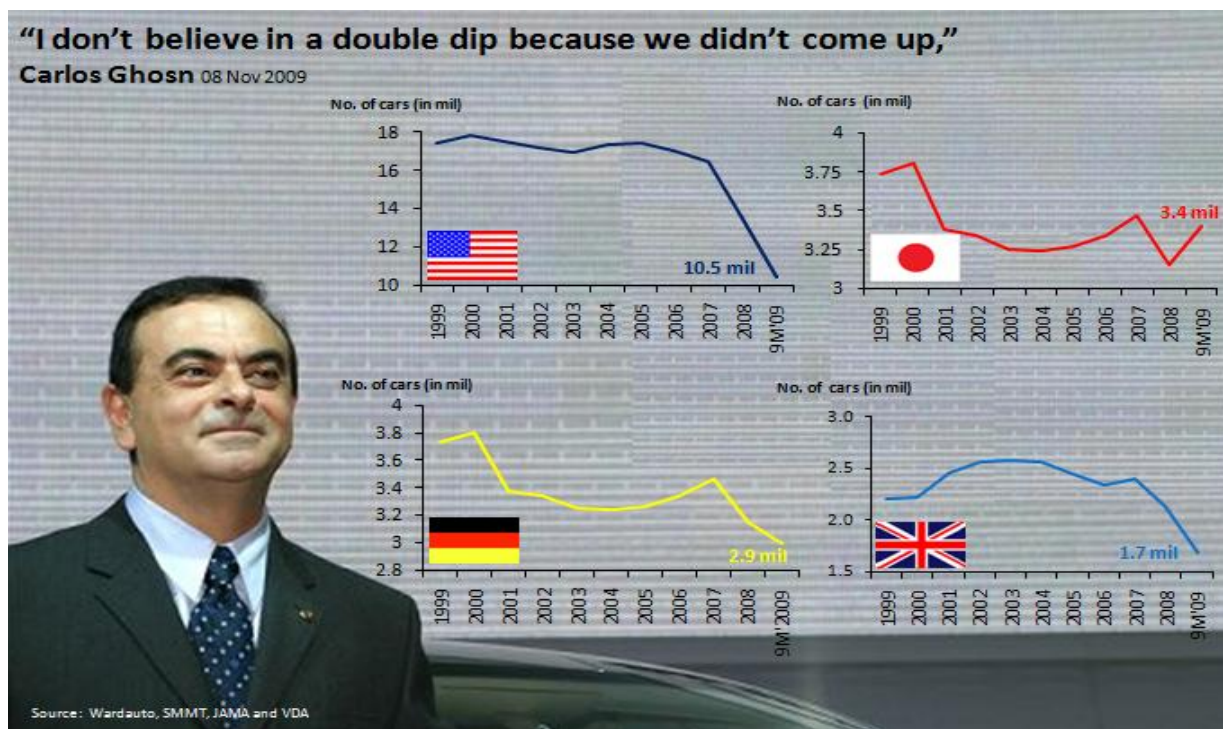


Figure VI: Auto sales in key global markets, ten year trend 1999 - 2009.

**Banks:** Finally there remain the banks, where the GFC started. I will not revisit the toxic asset issue and the efficacy of the bank rescue plans, having covered that in detail in the previous *briefing*, other than to remind readers that the toxic assets remain toxic, the drag effect on bank balance sheets and thus on fresh lending remains, and that despite the huge recapitalization efforts the G2 banking system remains fragile. This also means that the financial sector will not rebuild its employment base that fast, suppressing services employment growth; neither will its tax contribution rise to former levels for some time. That's a further drag on the US and UK economies in particular, which built an unhealthy dependent on finance in New York and London for both taxes and white collar jobs. Neither financial centre has a ready replacement for either the taxes or jobs lost.

What I do want to highlight is the next problem- the consumer, and commercial real estate. Given the GFC has moved beyond its financial crisis roots and taken down the consumer, banks with large books of consumer loans, auto and credit cards loans are in the frontline for the next wave of rising defaults. Historically, consumer loan defaults have followed unemployment closely, and given the dire unemployment situation that's a worry. The largest US banks most at risk here are Bank of America, JP Morgan (having acquired Washington Mutual's large consumer portfolio), and Citibank (see *Figure VII*); but of course there are many more smaller banks as exposed. Most UK banks are heavily exposed to the consumer. I have not looked at Spain and Ireland, but I would assume the same. In addition, commercial real estate is only now beginning to suffer, as debt is rolled over and landlords face problems with severe drops in yields and occupancy.

## US major banks, Q3 2009 net income and composition of loan book

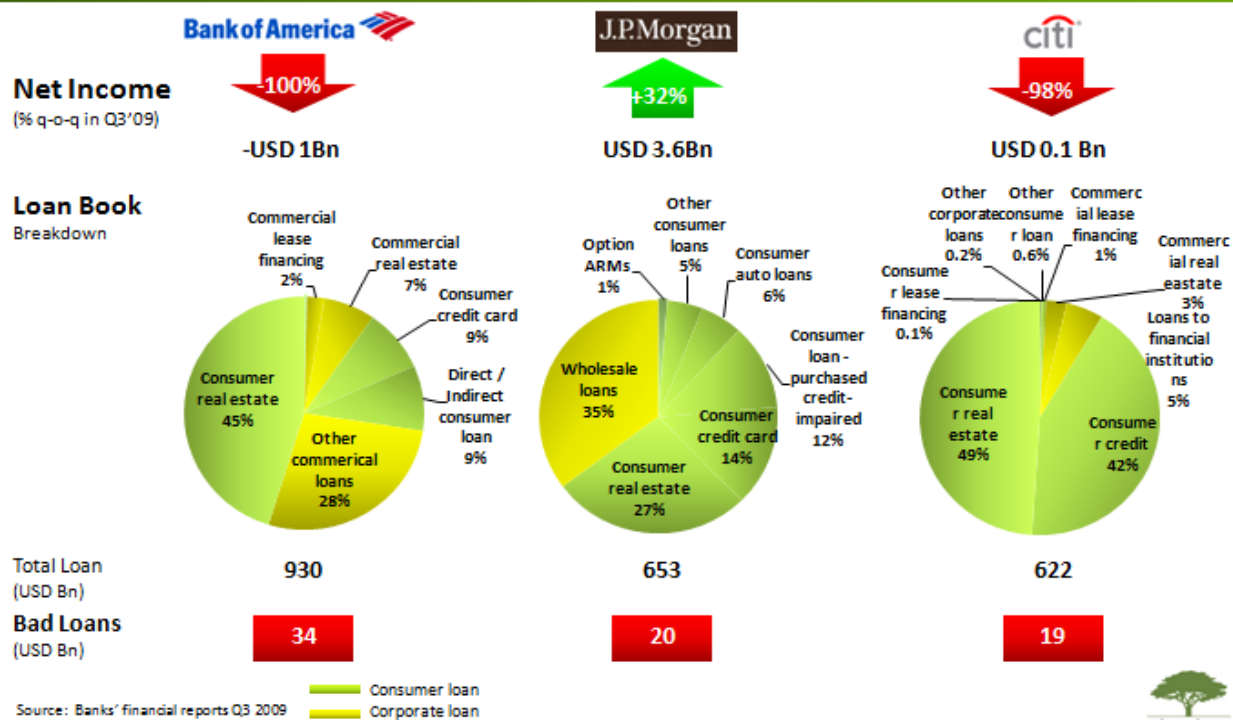


Figure VII: US major banks, Q3 2009 net income and composition of loan book.

**In conclusion**, our tour of core economic indicators in the G3 economies does little to support the extraordinary performance of the markets and continued optimism. The GFC was not just a bad dream. Signs are that recovery will indeed be slow and painful. Yes, emerging markets and the broader G-20 base looks healthier, particularly in the BRIC countries, but their overall impact on world growth remains limited by export dependency on the G3.

Given the data hasn't improved much, neither has my cautious view. The world really is not that much more of a better place, as an economy, than it was in April. But events since April have proven it is possible to have **asset prices rise, whilst economic activity declines**. This is the real 'decoupling'. The core question is why, which gets us to whether this is healthy, and whether this is sustainable. Such a divergence from underlying fundamentals usually signals price bubbles, particularly when the fundamentals are so weak, and the range of assets so uncorrelated.

### The Unreal Asset Markets

Given the collapse of investment confidence only a short while back, one would expect investors would return to low risk assets when they finally let go of their cash positions. Perversely, the riskiest assets have performed the best, a correctly labeled 'dash for trash' from early summer onwards. Punters didn't seem to find my previous jokes about buying Citibank funny-they actually went and bought it-along with every other technically insolvent bank. Risky emerging markets equities have almost doubled, along with everything else.

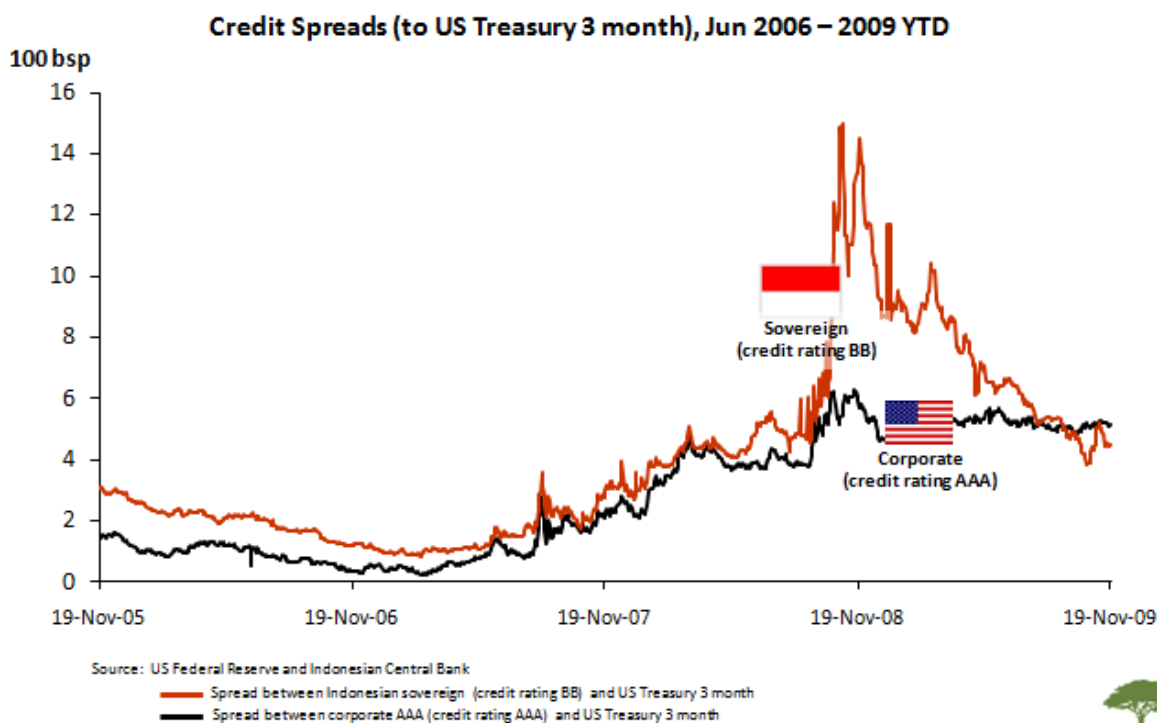
**Bonds:** That's not to say low risk assets haven't done well. The US treasury market has attracted large flows-80 billion USD from US retail investors alone this year. Just as well, given the volume of debt the US has had to issue to fund its stimulus. Despite the bluster about the rising risks of holding the dollar, foreigners including the Chinese have continued to buy treasuries. Demand has been so strong for the latest issue of short duration treasuries their yield has turned negative!



Figure VIII: Bond market performance, 2009.

But investors have also piled into risky bonds, particularly emerging markets sovereigns. The JP Morgan Emerging Markets Bond Index is up 24% and Indonesia 35%. The VIX, the traders favourite indicator of equity market volatility and a good proxy for risk aversion, has declined to almost normal levels from the meltdown status in Q1, signalling a return to risk assets. The risk investors perceive for emerging markets bonds have dropped to the same level as those of the best blue chips of corporate America (as measured by the spread or extra yield investors demand for holding riskier bonds over US treasuries-see *Figure IX*). The spreads for AAA rated US corporations remain high by historic standards. In 1994 there were fourteen AAA rated corporations in the US, today there are only four, so investors may have a point. But to see an emerging market bond priced the same as Exxon or Microsoft makes little sense. I have used the spread on Indonesian Sovereigns (BB rated), versus US Corporate AAA's below.

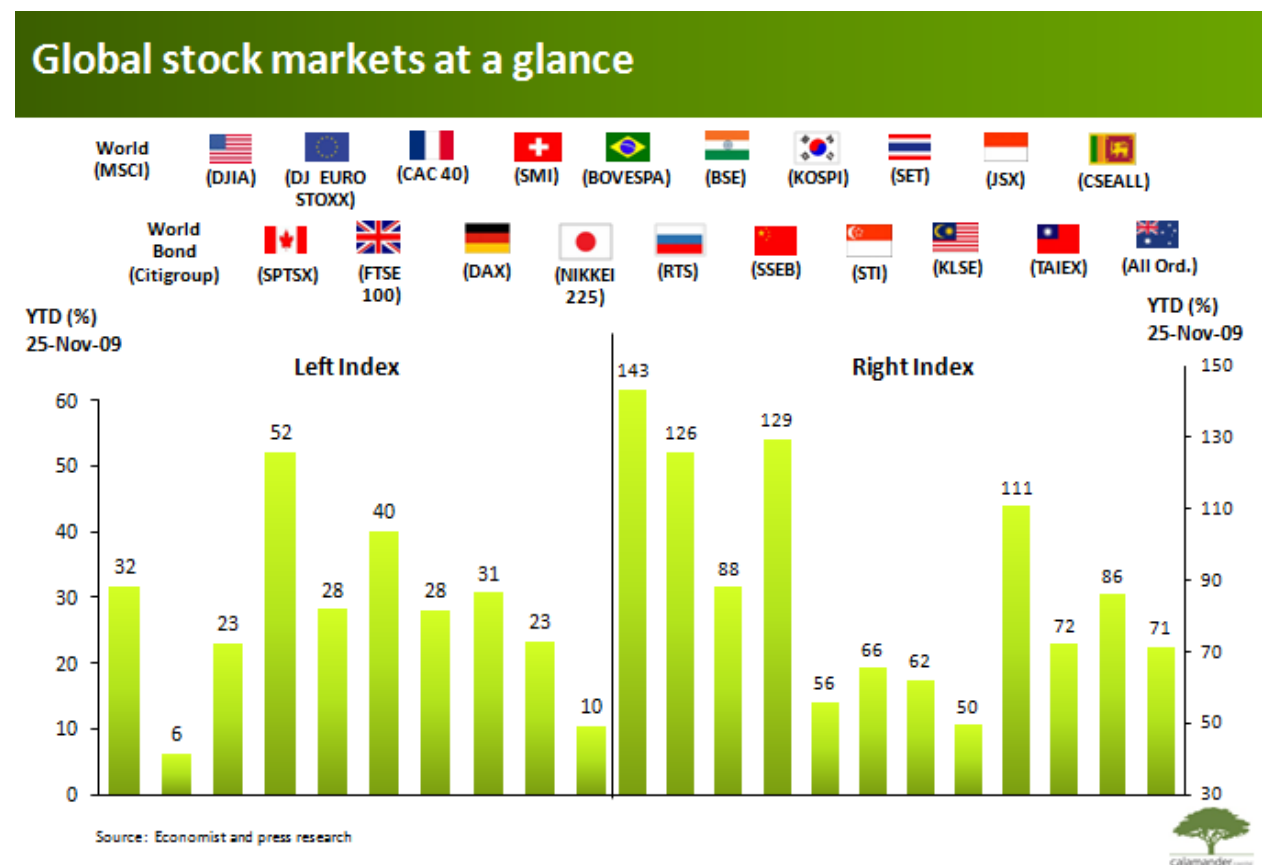
## Risk appetite for risky EMs back with a vengeance



**Figure IX:** Risky bonds spread to US treasuries, 2009

Investors are saying that they don't trust the best of the US much anymore, but now view risky emerging market countries as equivalent or better-countries they used not to be able to place on a map. The world has changed indeed. If you are looking for signs of a bubble, emerging markets bonds may be a good place to start (and EM equities a good place to follow).

**Equities** have rocketed on the rebound. Again, investors have driven up all markets on the risk spectrum simultaneously. As with EM bonds, the least liquid and most risky ‘casino’ markets, such as Russia and China, and tiny new frontier markets such as Sri Lanka, have been bid up the most (see *Figure X*). For the emerging equity markets, 50% is the minimum rise. Many are over a 100% up, including Brazil, Russia, China and Indonesia. Even Citibank stock is up 14% and Barclays 181%.



**Figure X:** Equity markets performance, 2009.

Flow data indicates that US retail investors, who traditionally buy US equities, are still burnt from the second major US market meltdown in a decade and have yet to rejoin the new party on the US markets. The US rally has been driven by institutional investors. Retail US investors, never known for straying too far from home, have discovered the emerging markets. They have bought over 50 billion dollars of EM equities this year. If this is a permanent ‘discovery’ of the new ‘new’ world by Americans it will bode well for EM equities in the future.

**Real assets and commodities**, usually an inflation hedge and on the riskier side, have done exceptionally well. Residential **real estate** has recovered, with Asian residential surpassing peak prices achieved in late 2007. **Gold** has reached new peaks, up 40% year to date. **Oil** (+84%) has recovered strongly. The **metals** have rocketed, with Copper (+93%), Aluminum (+32%), and Nickel (+61%) as examples. Agri or **soft commodities** have also provided supernormal returns, with Tea (+32%), Coffee (+20%), Sugar (+96%), Orange (+49%), and Rubber (+58%), as examples. And to remind us economic fundamentals may not be behind this frenzy, the best performing asset of the year turns out to be Chinese Garlic, which has more than quadrupled since March. Now you know what you have been missing!



**Figure XI:** Real assets markets performance – commodities 2009.

The riskiest and most illiquid of markets, the **art** market, was in cardiac arrest at the beginning of the year. Both major auction houses were facing major financial difficulties, caught short on price guarantees they offered in 2007/8. Come the latest New York autumn sales and it's another 'recession-what recession?' real asset market. Estimates were not just beaten, but often by multiples, capped by a boom era USD 43.8 million for a Warhol silkscreen appropriately titled '200 One Dollar Bills'. That's one bill for every 10 billion dollars in fiscal and QE stimulus the US government has spent to keep the US economy afloat, so that Sotheby's and Christies could live again.

The strongest phenomenon here is the return of **gold** as an asset class. Gold demand for actual use is dominated by India (as jewellery, especially for marriages). But India has been a net seller this year. Demand is being driven by investors, not users. Prices are tracking the rise of the physical holdings of gold bought by exchange traded funds-the easiest way for small investors to enter the market.



**Figure XII:** Real assets markets performance - real estate, gold and art 2009.

### Liquidity Not Fundamentals

Are these market performances justified? I think not. Economic logic has been defied because of liquidity. A rush of cash to the head can turn around the most depressed of markets, if that cash has nowhere else to go. Three factors combined for this rush. The first is the 'cash effect' of recessions: all economic actors, be it households, corporate, or banks, freeze spending and hoard cash. The US has been in technical recession for two years, time enough to build up a considerable cash mountain. It is what we recommended our chamber of commerce members do last year. Yes, some of this has paid down debt, but that's about 10-20% to date. So far, so normal.

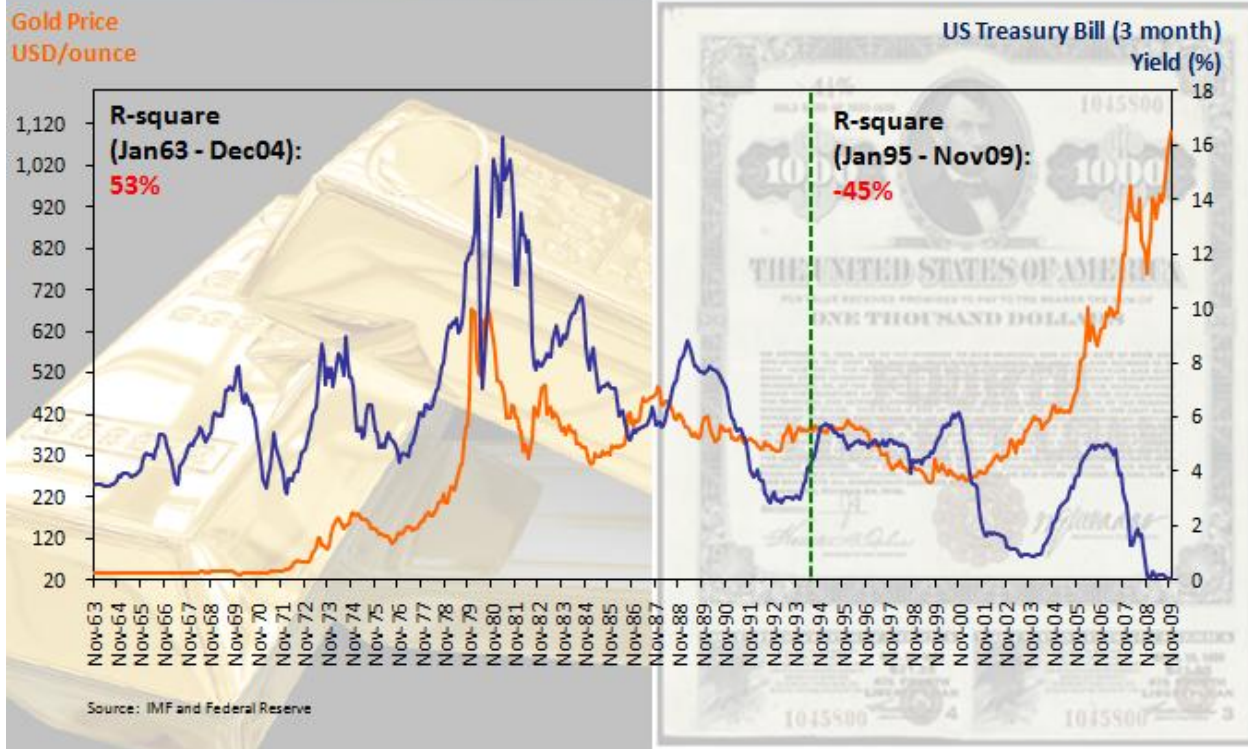
Meanwhile, governments have pushed an extraordinary volume of money through the economy. The size of this stimulus and its partner in quantitative easing I covered in detail in the *April Q1 briefing*, but in essence I estimate it totals the equivalent of 2-3 years of trend rate growth in global GDP. The fiscal stimulus is over 3 trillion dollars, and quantitative easing the same again-the Fed alone having bought 2.2 trillion dollars of assets. Given the roughly 60 trillion dollar world economy GDP grows about 2.5-3 trillion in a good year, that is some stimulus.

Finally, the most aggressive monetary easing in history made holding cash a fools game, with real interest rates zero or negative in most OECD countries. All this cash had to go somewhere, and not stay on deposit. After a period out cold, investors have returned to the markets, any markets, with a vengeance. This is not a return to fundamentals; this is a return to liquidity, with few alternatives.

Is this a **dollar carry trade**, i.e. a boom financed by cheap borrowed dollars, as Roubini, the Chinese leadership and others claim? I think not. There is a difference between a liquidity driven bubble (as appears to be this case), and a leverage driven bubble. There is little evidence that investors are gearing up again dramatically. The repo market, where banks lend against securities, remains muted. Cheap borrowed dollars are not funding the current boom. Cash is.

**Investment logic suspended:** Liquidity may be driving the asset boom, but it is directionless. Investors do not know what they are doing. The most risk averse, protective assets (treasuries) are rising at the same time as the riskiest assets (emerging market equities, commodities). Investors are loading up on assets that support a benign view of inflation (government bonds) at the same time as they are loading up on gold-the ultimate inflation hedge. This does not make sense. If you believe inflationary risks are high and go long gold you should be shorting bonds. I have tested that logic and looked at the correlation between gold prices and inflation as measured by 3 month US treasury yields over time (*Figure XIII*, for those unfamiliar with previous *briefings* I use 1963 as the base for long time series, a great year for port).

## Decoupling



**Figure XIII:** Gold prices versus inflation/US Treasuries 3 month yield, 1963 - 2009.

For most of this period, 36 years, the relationship was pretty strong, with an R-squared (a measure of correlation) of 53%, i.e. gold rises with inflation, and declines when rates decline. Of note is the strong rise in gold prices during the 1970's, exactly matching the hyperinflation of the time. For the past decade, the relationship has reversed, particularly since the 2007 recession. Gold has *risen* as inflation declines, with a *negative* correlation of -45%. One explanation is gold has risen purely due to risk aversion and loss of faith in the dollar, but that doesn't fully match the facts. Investors have also bought treasuries as a safe haven when risk averse, and if lack of faith in the dollar is the problem why buy dollar treasuries?

This is a big problem for investment theory, and by default investment advisors. For most of this century modern investment concepts have been underpinned by two core beliefs. The first is the notion of efficient, rational markets; and the second is portfolio diversification, with well established patterns of correlation and non-correlation between defined asset classes. Both suffered a near death experience after the September 2008 Lehman Crisis, as did the oft recited nonsense of the 'buy and hold school' for equities. Diversification and 'efficient frontiers' in asset allocation proved utterly useless, as all asset classes collapsed in tandem.

The **diversification concept**, although logical, remains seriously damaged. What went down together is rising together. How can this be explained? Else standard investment logic remains suspended, or investors are confused, uncertain as to which of the competing alternative scenarios—from extreme bear to charging bull—to chose. In essence, we have stupidity or confusion. Ever hopeful, I believe it's the latter. My view is that widespread uncertainty, and the contradictory views of 'the experts', has created large populations of believers in completely contradictory asset strategies. As a result everything-black or white—that is theoretically uncorrelated has gone up simultaneously. It's Alice's Cheshire cat. If you don't know where you want to go, any direction will take you there.

**Market sustainability:** Given this boom has been liquidity driven, asset class neutral, and ignores fundamentals, is it sustainable? I, like many observers, have been sitting waiting patiently for the autumn correction. October showed signs of a return to sanity. A few better than estimate earnings reports, and a G-20 meeting reaffirming governments will keep the stimulus taps on and ultra cheap money for a good while longer, and the bulls were off again. Investors were looking for an excuse to keep the party going, and there is enough liquidity in reserve with those US retail investors I mentioned. Their cash money market funds peaked at 3.8 trillion dollars this year. They have since deployed only 500 billion, leaving 3.3 trillion—a huge sum. This liquidity remains a strong argument for the bulls who believe the market will be sustained despite being fairly valued. I remain convinced this year has been an temporary bull period within the longer term US bear market that is now two years old, and will age for some time. Many such intermediate bulls will come and go. Fundamental economics remain poor, recovery weak, prospects for an easy monetary exit uncertain, and structural debt and fiscal issues dire. I will continue to sit firmly on the sidelines with fellow Vulcans waiting for it to end badly, and no doubt be proven wrong, again. That's why gloomy economists don't make any money.

### The Great Debate: Inflation vs. Deflation

Keynes would be proud. The world's policymakers and central bankers have found a new consensus for government intervention and demand stimulation in the event of a major recessionary drop in demand. Add in the kind of social welfare and unemployment 'stabilisers' invented by the Europeans, and governments believe they can flatten out the extremes of cyclicity and avoid the damage, much like an insurance company flattens out investment cycles using reserves for guaranteed policies.

The problem with this model is that public demand steps in to substitute for private demand, and public debt takes over from private debt. In short, *the problem is nationalized for the long term.*

The G3 have just done exactly that. This creates two key risks. Firstly, the threat of potential long term inflation and debt repayment burdens when growth recovers, as governments have to raise interest rates to ensure demand for public debt is sustained. As soon as private demand returns, private sector investment and demand for credit returns with it. The sea of government debt has to compete. Meanwhile, the national currency has been weakened by the deterioration in state finances, damaging

the attractiveness of their debt to foreigners if they smell a depreciating holding currency. In short, investors have better things to be buying, and higher rates are the only inducement. This was Britain in the seventies.

The second risk is the opposite—a market of damaged consumers who shift to saving and reducing credit rather than spending, creating a deflationary spiral in a world with far too much capacity for just about everything. The economy stagnates, continuously flirts with deflation, and piles on more public debt as the state regularly tries another stimulus package to persuade weak consumers to spend. Over time, it takes more and more public debt to produce less and less GDP growth, with fewer real jobs. Consumers work out that the public debt is actually their long term liability, and turn even more cautious. The only hope for limited growth then becomes exports. It is the economic equivalent of permafrost. This was Japan in the nineties. This remains Japan now, twenty years after its own GFC in 1989.

Both of these scenarios are real risks, hence a lot of the confusion in the markets and in asset buying patterns. I don't have the space to go into a discussion of the merits of both arguments. And given the state of flux in the economy at present, either scenario is plausible. So I will instead focus here on where my views are at present.

I worry much more about deflation than inflation risks now, and will for at least the next two to three years. By inflation risks I mean an inflation and dollar crisis, not a gradual, very slow tightening back to a 'normal' range of 2-3.5% in the G2 (US and EU), which is to be expected. Whilst inflationary risks are out there, it will be a medium term problem unless the Fed does something completely stupid with virtually no tightening at all.

For the deflation scenario, we need only look at Japan. Japan is the best case study for three core issues now facing the US, and by default the world economy. Firstly, how they handled the banking crisis (or how not to handle one). Secondly, what happens when you end up with a generation of permanently damaged consumers, and by extension damaged private demand. Finally, the result of following a policy of continuous government demand stimulation, paid for by public debt. Could the US turn into Japan, with a permanent loss of output and a conservative, less active consumer? It's a scary thought, but lies at the heart of assessing what form the recovery will take and how long.

I have to admit a bias, in that I worked in Japan for several years, have monitored their economy ever since, and been un-relentlessly critical and bearish. For the record, Japan remains one of my favourite countries—great culture, food and aesthetics—just lousy economics and demographics. My second bias results from working on the wreckage of the Indonesian banking system for six years after their crisis, and witnessing the level of damage to an economy a bank crisis leaves as legacy. I may therefore be over gloomy, but the lessons of Japan are still worth heeding.

## Damaged Banks

I have covered this in the last *Briefing*, to which the reader should refer. In summary, financial crises are simply bad news. Normal recession recovery patterns don't apply; a three to five year cycle to return to trend rate growth is standard; credit extension takes time to return to normal while both banks and consumers work through bad debts and deleverage; and impaired assets take a long time to clear. Again, as went Japan, there goes the US, minus the prop of 1990's Japanese savings.

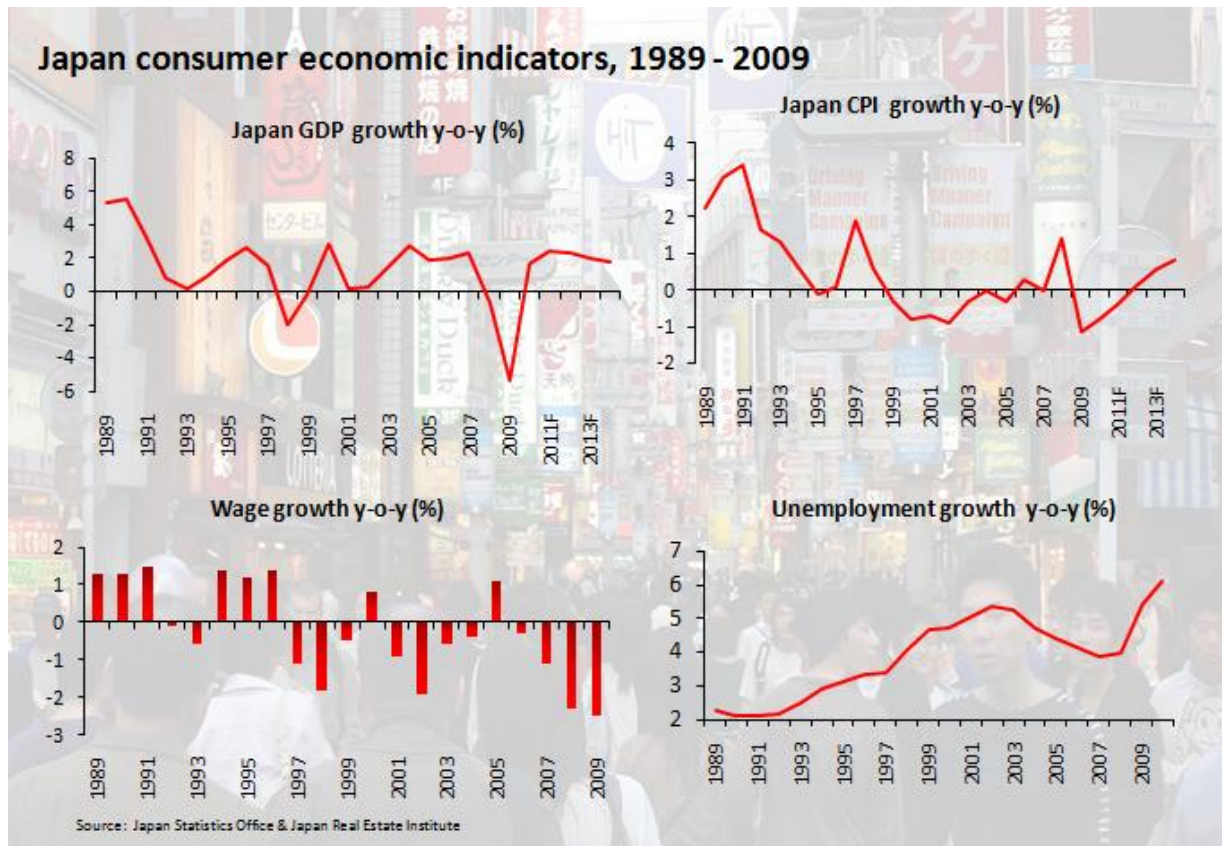
Rogoff and Reinhart, two Princeton academics, have analysed the past eighteen post war financial crises in a recent book ('this time is different: Eight centuries of financial folly'). They come to the same conclusions I have summarized above. Rogoff and Reinhart suggest if the US conforms to type, it's going to be *a four year recovery with a long period of persistent unemployment*, restrictive credit, and continued deleveraging by both households and businesses. That is my vote.

The US has also just repeated Japan's mistake of *leaving their banks with most of the toxic assets on their balance sheets* rather than removing them into a state 'bad bank' and nationalizing banks if required—the Indonesian and Korean crisis model I strongly support. The UK also followed the latter model—Gordon Brown got it right. The half baked re-capitalization of the banks provided by the US is less effective, because the poison remains in the system. The Japanese did the same on the assumption that the banks could slowly grow their way out of the problem. Slow became the operative word—over a decade was required. There are no short cuts via assisted 'self recovery' for bank crises. The US missed the chance to take the pain, put them in an ICU, and temporarily nationalise. The availability of credit, and thus economic recovery, will suffer as a result.

## Damaged Consumers

**Japan's lost decades:** I don't need to repeat the story of Japan's so-called 'lost decades' following their own asset and investment bubble collapse in 1989. In essence, the economy was left permanently shrunken, with a huge level of overcapacity and dramatically reduced credit growth, investment, and consumption. Faced with the huge decline in private demand, the government resorted to endless rounds of stimulation, each one less effective than the last. The key issue is that consumers have never been able to pick themselves up again, so public stimulants had to replace private demand.

When Japan did recover, it found that it was a jobless and weak recovery. This is the risk the US faces. A quick summary of the data (*Figure XIV*) shows GDP growth has bumped around -0% to +2%, with bouts of deeper negatives for 20 years. The net growth is zero. Corporate profitability came back, but new job creation remained weak. As a result, wage growth in Japan has been negative, and unemployment climbed from nothing to Western levels of over 5% in a decade, where it remains. Land and house prices, the reference point for a consumer's net worth, have never recovered. This leads to a strong negative 'wealth effect'. Small wonder that consumer spend has been at a standstill, and the economy has been in and out of deflation ever since (it is currently back in deflation at -2.2%).



**Figure XI:** Japan consumer economic indicators, 1989 - 2009.

**US employment:** If there is one clear single signal that the US may repeat Japan's pattern of long term damage to consumption, it's the employment picture. The current official US unemployment rate, 10.2%, is dire. But this figure grossly underestimates the problem, because the official numbers exclude many inconvenient truths (those who have given up job seeking, part timers, new entrants to the workforce etc.). *This total un-and under-employed figure for the US is approaching 18%.* A 'jobless recovery', as looks likely, would permanently impair an entire segment of the population and thus their demand. And for those that doubt the potential of a jobless recovery, the US has already proven the case. *The US has lost all the employment gains it made during the decade long boom.* It employs fewer people today than in 1999.

## Total US unemployment 2009



154 mil  
Total no. of people in  
US workforce



Source: US Bureau of Labour Statistics

Figure XV: Total US unemployment, 2009

The last number in Figure XV is of concern: 2.3 million additional new entrants to the job force. Assuming that rate continues, this means over 10 million extra jobs need to be created for the young over the next five years. The highest rates of unemployment in the US are the young: 15% for 20-25 year olds, and close to 28% for 16-19 year olds. Britain and Europe have the same issue, with 20% 'youth' unemployment.

A recent article raised the risk of a *generation of young scarred by unemployment at the start of their careers*, which leaves a permanent change in attitude and reduced earnings. Again, the case study was Japan. This group in Japan has ended up more risk averse than their peers, perfectly happy to work for the government, cautious on spending, and better savers. They stay at home longer with parents, lowering new household formation. This does not sound like the kind of high tech start-up entrepreneurs the US and the EU will require for the next wave of growth. Over the next three years at least 6 million young people will enter the US workforce, at the worst time since the great depression. Without policy intervention, they risk becoming a lost generation.

Finally, there is one difference to Japan, and it doesn't help. The US has superior demographics. Faced with a jobless slow recovery, population growth becomes a disadvantage. The US population is now 300 million, having grown by 30 million since 1999. *It is expected to continue to add 2.5 million people a*

year. The EU and Japan can get away with lower growth because their populations are static or shrinking, but the US needs its trend rate GDP growth of 3% plus to maintain real growth at a household level.

So unemployment will be the main drag for the US economy, 70% of which is consumption. *There will be no real recovery until employment recovers.* This means back to the 5% trend rate at least. Job creation has to be high enough to not only absorb the unemployed, but take on young new entrants and a growing population.

### Damaged Public Finances and Debt

During 2009 all OECD countries have followed Japan's post crisis policy set two decades ago—a major stimulus package, backed up by quantitative easing (printing money by another form), and very easy money (i.e. interest rates close to zero percent). Clearly *the single biggest structural issue for the next twenty years will be the US government's debt mountain*, which now stands at 85% of GDP, and rising. This is the price of substituting public demand for private, a pattern repeated in the UK, and to a lesser extent in the rest of the EU. Remember the EU limit pre crisis was for national debt of 30% of GDP, a conservative but fiscally responsible figure.



**Figure XVI:** National debt % of GDP, 2009

As with Japan, the US cannot but be poorer as a result. *The debt will consume much of the public's earning power through taxes, and severely constrain public spending* and other budgetary needs. This has to affect consumption, because consumers ultimately have to pay the debt back through taxes. As goes the US, so go Britain, most EU nations, and others with high national debts burdens.

Is it possible, as Japan has demonstrated, to have national debt climb to a very high level, yet maintain low interest rates. This enables low yields on that debt (i.e. low interest), and contains inflation. Japanese debt more than doubled from 60% to over 140% after a decade, and after 20 years has reached 219%. Yet yields in Japan collapsed and remain below 1% today.

It is questionable whether the US could repeat that feat, or if it is desirable to do so. Japan's ultra low interest rates are part of the problem not the solution. Consumer activity suffered such lasting damage, Japan has been in and out of deflation ever since. Saving not spending is a good and necessary response for overstretched households for a few years, but if they never get back to the shops and simply save, the economy never grows again.

Japan's ability to absorb all those government bonds (JGB's) depended on a vast pool of domestic savings kept onshore. Most of these savings are turned over to the state via the largest deposit taking institution in the world-the Japan Post Office, which simply rolls it into JGB's. Deposits in private banks go the same route. US households are rebuilding savings but will never get to the Japanese levels of the early nineties. And, we hope, they will go back to spending again at some point. That means that *the US will have to go to the international debt markets*, as will the UK and other big EU borrowers. This reliance of foreign buyers of debt will make it a lot harder for yields to stay this low forever, despite my leaning in the direction of a muted recovery and therefore low inflation pressure for the medium term. My deflation scenario is good for three years or so. After that, the world will return to worrying about inflation.

If the US is to avoid Japan's fate with a permanently high national debt, higher taxes, and lower demand; or the alternative in a major inflation problem, it will have to pay down debt to a sustainable level. That means taxes or budget cuts, and likely both. A recent IMF paper on debt sustainability concludes that *the US will have to increase taxes and reduce spending to the tune of 8% of GDP* to get national debt back in the comfort zone of 60% of GDP, a huge hole to be filled in a 14 trillion dollar economy. It is no accident that this number is close to the level of cumulative lost output from the US economy, given that the loss has been plugged by the state using debt. But adding further to the tax burden is politically unpalatable. Given the Healthcare budget has gone up, that means the savings have to be found in the rest of the budget. The US simply won't be able to afford what it used to. This will apply to all areas of public spending, including investment in infrastructure that the country needs, and in military expenditure and reach. Again, the same issues, and politically difficult budget cuts, will apply to the EU.

## Conclusions

What are the lessons here? The US, and to a lesser extent the EU, still have some serious problems and need to continue repair-work. For the next three years minimum, I expect a pattern similar to that of post crisis Japan:

- Corporate profitability will return, but new job creation will remain weak.
- This means a jobless recovery, with a disenfranchised, unemployed underclass a permanent fixture, restraining wages.
- Several million baby boomer children will demand entry to the job market, but may struggle to get a solid start to work-life. This will add pressure on jobs and wages.
- A growing population will add even more pressure on jobs and wages.
- The public sector will take on a much bigger role to make up for reduced private demand and lack of private sector employment, Japan style.
- Wage growth will be restrained, so household balance sheets won't grow.
- Higher taxes and reduced public services will make consumers feel poorer.
- Consumers will continue to deleverage and save, for at least another three years, perhaps permanently.
- Credit will not revert to normal for several years, as the banks remain weak and toxic assets remain on their balance sheets.
- A second wave of bank credit defaults will arise in the consumer loan books (especially credit cards) and commercial real estate.
- The decade long trend for decreasing taxes, direct or indirect, will reverse.
- Even if consumer price inflation remains benign, the return of energy inflation will function as an additional tax on the consumer.
- Overcapacity will suppress inflation for some time even as demand returns, as it did in Japan
- This is the situation before policy risks. If the Fed responds to concerns about unsustainable asset price bubbles and tightens early, a double dip recession would ensue.

Those who doubt the parallels with Japan are kidding themselves. The US is already a shrinking economy in terms of its employment base and household wealth, but unlike Japan has a growing population to share this among.

It goes without saying that if this paper is correct, *the risks are greater for deflationary pressures than inflation* at this stage. When inflation re-emerges, it is likely to be benign. There is still a huge amount of overcapacity around the world, and that combined with limited or zero growth in average household income will restrain inflation. Oil remains, as ever, my only consumer price inflation concern. The inflation hawks are three years early. Asset prices will behave differently of course, and be driven by liquidity and speculative interest. They are likely to continue to rise, irrespective of economic fundamentals which argue for a major correction.

What about the argument that **Asia** will save the world? It is true that the GFC has accelerated the relative decline of the US. What was to have been a thirty year rise to global dominance by Asia will now be done in twenty. But in 2009 we all remain dependent on the health of the fourteen trillion dollar US economy, Asia more so than ever; and we will do so for some time yet. Asia remains export dependent, principally on the US and EU. As I have mentioned before, no one else is ready to replace the US consumer yet: the Europeans will not, the Japanese cannot, and the Chinese don't know how yet.

For both the US and Asia, a slightly shrinking US has advantages. US households need to restore the health of their balance sheets by consuming less, paying down debt, and restoring a savings rate of at least 5-7%. Reduced demand from US consumers is the only way the Asian export driven economic model will be forced into accelerating self sustaining domestic demand. This requires building up the social safety nets Asian consumers require to persuade them to relax a little. Only then will they save less, and spend more.

Will this be a permanent 'Japan lost decade' for the US? Fortunately, I don't think so. Rumours of the death of the US economic model and the dollar are greatly exaggerated. The austerity period will be longer and more painful than many imagine, which is what I have tried to convey in this paper. But the structural strengths of the US economy-its openness, dynamism, availability of finance, and above all innovation and entrepreneurial risk taking will ensure its resurgence after three to five years of serious and necessary repairs. The US has a remarkable ability to dig huge holes for itself, and then climb out again. They then repeat the process, on a seven to ten year cycle in my view, but that's another story.

---

**Global Disclaimer**

This research note and/or opinion paper, article, or analysis has been released by Calamander Capital (Singapore) Pte Ltd., or its parent company or affiliates, to professional investors, clients, and business members of the British Chamber of Commerce for information only, and its accuracy/completeness is not guaranteed. All opinions may change without notice. The opinions expressed, unless stated otherwise, are not investment recommendations, or an offer or solicitation to buy/sell any funds, investments or other services of the Calamander Group, Calamander Capital, or its affiliates. Calamander Capital does not accept any liability arising from the use of this communication.

**Copyright © 2009 Calamander Capital Singapore Pte Ltd.** All rights reserved. Intended for recipient only and not for further distribution without the consent of Calamander Capital Pte Ltd

For further details, please contact [marketing@calamandergroup.com](mailto:marketing@calamandergroup.com).  
Calamander Capital (Singapore) Pte Ltd (Co. Reg. No. 200723396M)  
MAS exempted fund manager  
85 B Circular Road, Singapore 049437  
Tel: +65 6723 8129  
Fax: +65 6491 1227  
[www.calamandergroup.com](http://www.calamandergroup.com)



[www.calamandergroup.com](http://www.calamandergroup.com)