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Child Eyed Wisdom and the Triumph of Fundamentals

Introduction

Voices proclaiming the end of the worst economic period since the 1930s have been sprouting for several weeks now. Statements from the Federal Reserve Bank, the United States Treasury, the IMF and the OECD have all released outlooks in the past month that the Emperor - that is the American economy - will soon take command again. The obvious question of course, would be "What is the evidence for such a statement?" Could it be employment figures? No, unemployment rose to 9.8% in September, but as we have stated before, these statistics are futile as they leave out discouraged workers and do not fully account for the underemployed. Currency appreciation? Again no. The dollar has slid against the Euro, the Yen (down 12% the past year), not to mention the rise of gold over $1,000 in September. Output? Output in the manufacturing sector declined in the past month since the U.S. manufacturing sector is operating at only 66% capacity[1]. Strangely enough, experts expected a rise in this indicator.

While such grim news may strike one as cynical, that is not our intention. A rise in equities and short-term increases in consumer spending have been the statistics used by the royal court of economic institutions to "dress" the appearance of the end of the economic downturn. Our contention is that fundamental analysis of micro and macro balance sheets is a better and more accurate measures of economic health.

This issue will explore the state of the U.S. economy, particularly its banking and financial sectors, demonstrating that fragility still exists. Until the financial sector is completely cleansed of the toxic assets, other sectors will not be able to expand and the economy will remain stagnant and bleak. Moreover, deflationary pressures continue to rise since credit markets remain to a large extent frozen, and firms look to pay debts by selling assets as quickly as possible.

Yet these trends are not universal as emerging economies (markets we have continuously promoted in the midst of this crisis) are continuing to accumulate hard assets in their own economies or gain access to natural resources through international agreements in order to expand growth and production capabilities. These facts are why we continue to emphasize asset allocation in emerging countries and commodities.

The American Prognosis

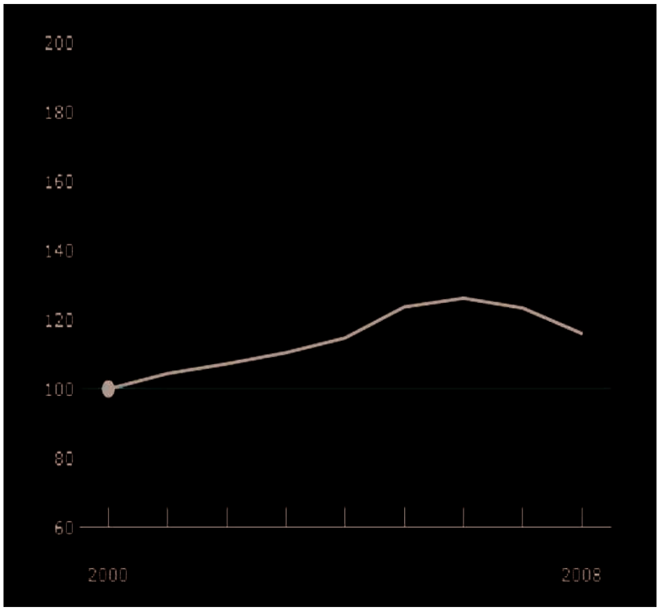
The core of this crisis rests in the feeble practices of the global financial system. Assets which were often inflated, if not worthless, were sliced and diced with other overvalued collateral and securitized multiple times into strategic investments vehicles to finance obsessive, deficit producing consumption patterns. Until global finance has purged itself of this practice and these instruments, the industry which we have described as the lifeblood of the global economy, will not recover. Unfortunately, current evidence suggests quite a bit of work remains in order to reach this point.

Recent developments at the FDIC exemplify the persistent fragility of the U.S. banking sector. The fund recently stated concerns regarding its future balance as a number of regional bank closures are sapping the agency of cash. The strong possibility exists that its balance sheet at the end of the year will go negative.

Presently, two options exist. The first is to tap into the FDIC credit line with the Treasury. Such a move may be necessary although it will not be taken well by the public, but for the present it shows concern over the FDIC's role as a manager to smooth out financial and liquidity hiccups. This will also hamper the FDIC's ability to be a guarantor of bonds, as companies such as GE and Citigroup used the fund earlier this year to support new securities in order to raise capital. The second option is for the fund to demand that banking giants such as Bank of America and Wells Fargo pay back fees owed to the fund ahead of schedule. The fees total over $36 billion and could reach $54 billion but many indebted banks claim paying upfront the fees drains much needed liquidity from their recovery efforts and puts them in danger. Banks paying the advances will reportedly receive Treasury bonds in a return. In short, the Treasury will pay interest down the road for healthy banks to risk their short term future and insure feeble banks. The failed bank list has now increased to 98, the largest number of banks since the savings and loan crisis but more importantly, the banking industry expects more to come.

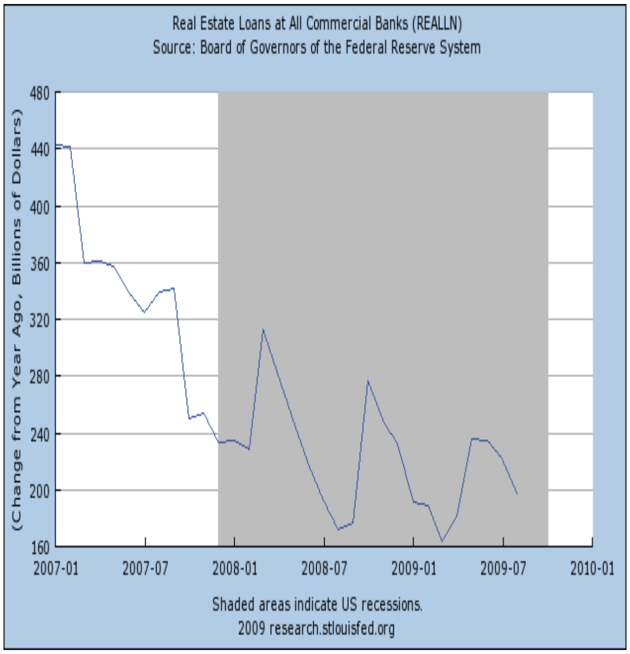
Of further discomforting news is that the floor of the U.S. housing market may still not have materialized. Some analysts look at the growth in construction spending over the past month (growth was a mere 1%) as a sign that the market's worst is over. To counter, examine Figure 1. It is a graph of housing prices charted against average incomes in the United States courtesy of the Economist. The graph demonstrates the affordability of houses. The chart uses an index of 100 as a base average and goes back to 2000, before the explosive rise of housing prices.

Figure 1



As is evident, houses are still approximately 20% above average incomes suggesting that the real estate sector will experience further stress in the near future because families are still not able to afford purchasing. Furthermore, Figure 2 represents the amount of real estate loans from commercial banks in the U.S. since January of 2007. Signs of stabilization aren't clear, which is a further reason to be cautious regarding the bullish proclamations.

Figure 2



Progress has certainly been made in this sector, but we advise patience and caution before considering an entrance into this market. The immediate past has demonstrated volatility and until such a pattern ceases, consumer confidence will not revive and the economy will be lacking a substantial source of credit. To that we should add that in the commercial real estate sector- as we indicated in previous issues – we expect a major bust that could potentially trigger losses that would exceed $200 billion.

The corporate sector also provides evidence for words of caution. Corporate bonds, while having raised funds in some places, are defaulting at explosive rates. In the first 8 months of 2008, 62 bond issuers had defaulted. That number has risen to 201 in the same time period for 2009[2]. That's nearly a 200% increase in defaults! For the foreseeable next 12 months, the corporate bond market will not provide a competent investment venue.

Yet the most important factor to fighting its way out of this crisis for the United States economy is for the credit arteries to be freed from its current state of congestion. This cannot be done by the wave of a wand but will require a restructuring of the foundations of the global financial system. Credit lines will not open at any significant levels until financial institutions are able to fix their balance sheets by freeing themselves of toxic assets (hundreds of billions are still on balance sheets) and they discover assets with the potential for appreciation.

Currently, the climate for American financial institutions is dim. Assets of financial institutions in the U.S. have declined to the tune of over $2 trillion during this crisis. We believe that a haircut of at least another $700 billion is needed for the system arteries to operate in a reasonable manner. Non-borrowed reserves at depository institutions rose an additional $60 billion this past month; a sign that banks are continuously hoarding money due to liquidity concerns. Eleven months ago this figure was a negative $88 billion. Household debt still is over $13 trillion and completed foreclosures jumped over 20% in the second quarter of 2009[3]. But "don't worry, recovery is just around the corner" the voices chant.

Banks are also wary about their future direction because they know the rules are about to change. Consensus has been reached by governments across the globe that the financial industry needs reformatting. Policy levers such as a Tobin tax, to higher reserve requirements, to higher capital requirements have all been discussed in addition to government regulation of the derivatives market.

These statistics and topics do not seem to make their way into traditional conversation when diagnosing the current economic environment. Rather, the gain in equities is often cited despite the fact that the majority of these gains come from cutting costs, i.e. firing workers (notice the rise in unemployment). But what has failed to be recognized is that such maneuvers are not sustainable; at some point you run out of people to fire.

Instead, we have been made to believe that because we don't see things getting worse, the economy must thus be getting better. After all, why should we worry about declining manufacturing production, frozen credit, and failing banks? Fundamentally, things are the same. The forecast is foggy with a chance for storms. The landscape may look different, the royal court may be shouting proclamations of wonder and excitement but the emperor is still missing his clothes.

Sluggish Future or Schumpeter's Fruition?

We have persistently proclaimed the promise of emerging markets in the midst of this crisis; the Chinese weiji concept as we mentioned last month. Economic theory in the twentieth century encapsulated this idea through the term of "creative destruction." Out of this crisis we expect the formation of global economics with a new face; globalization through regional integration by incorporating rising powers into a more level playing field. This notion will continue this month because emerging economies are sticking to fundamentals; growth through production and wealth from assets.

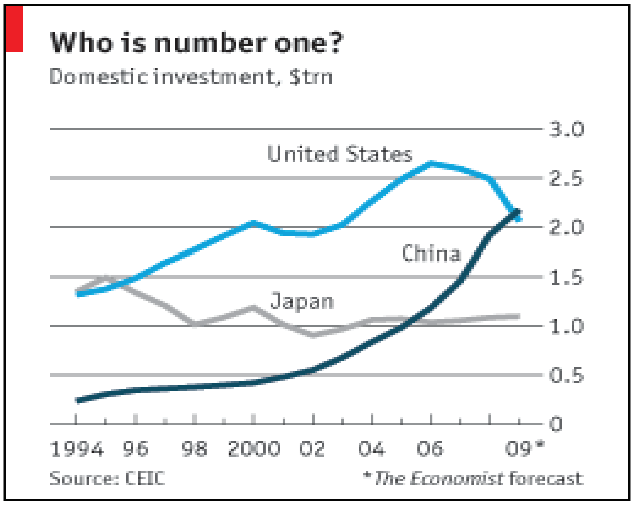
Our past issues have cited how the framework of globalization as an international economic system played a role in leading to the financial crisis. Namely, surplus nations such as China financed the deficit countries, specifically the U.S., to cover excessive consumption and spending patterns. Growth in western nations was paid for through exotic, toxic assets that were backed up by little, if any quality collateral. As our last issue hinted, the pattern may be reversing to create a more leveled and balanced global economy by way of a new global economic structure.

Shortly after our last issue, where some bold forecasts were made, China issued its first renminbi denominated bonds in Hong Kong; an encouraging sign in our belief regarding the formation of capital markets in emerging countries and a decoupling from the financial centers of the past. Further, and of greater importance, has been the ability for China to adapt to the chaotic circumstances of the global economy.

Its traditional export-led model for economic growth was endangered with this crisis as trade with the U.S. and the rest of the world slowed to where China's current account surplus has slipped to just over 4%. Additionally, the Baltic Dry Index[4] fell to a four month low in September, due to a decline in trade activity (although we would strongly recommend further examination of the shipping sector).

Yet growth estimates for China have been optimistically revised to be close to 9% this year, thanks to growing consumption patterns and credit growth (though this may have been directed to speculative purposes to a degree.) Fiscal stimulus in China has allowed the manufacturing sector to rise for the seventh straight month and hit a seventeen month high.

Figure 3


Who is number one?

Domestic investment, $trn

Source: CEIC

**The Economist* forecast

It's interesting to note that as figure 3 above shows, the productive investment activity (the one that creates assets and expands production capabilities) is still rising in China and it seems that is surpassing that of the U.S. Moreover, the renminbi continues to rise due to both a more balanced current account and increasing consumption (which is expected to rise 10% next year in addition to a 9% rise this year)[5]. Fixed investments could rise by approximately 14% this year (the rates will be higher in the poor, western part of China) allowing for continued productivity growth and new employment opportunities for the country's millions of poor people. Empowering those poor persons implies significant consumption increases which in turn will generate growth.

In addition, China is striking deals across the globe to meet its domestic need for production and sustained growth. Since our last newsletter China has signed deals with Australia, Qatar, Iraq and Nigeria to import energy and held a launching ceremony on an Uzbekistan-Turkmenistan-Kazakhstan pipeline for natural gas.

The result is an economy and a region decoupled from Western markets but more importantly prepared for currency appreciation that will systemically recalibrate global imbalances by strengthening domestic policy potential. This will arrive due to China's conscious attention to fundamentals, fixed investments, a balanced current account, and a healthy productivity growth rate.

China is not the only emerging market on this trend of securing assets and prospects of growth. This past month also saw Russia sign a gas deal with Turkey for the construction of a new pipeline but the big announcements came in Brazil. Brazil, which is growing at 3% this year, declared in September that the South American giant had made dramatic discoveries of oil (possibly up to 100 billion barrels worth) off their coast in pre-salt areas. To a lesser degree, the selection of Rio de Janeiro for the 2016 Olympics, also provides optimism for the Brazilian economy. Infrastructure development will employ more than 10 million people in a region where they had been pushed back into poverty as a result of the economic crisis.

Additionally, Brazil's sovereign credit rating was upgraded amidst global economic turmoil and its currency the real, the globe's second best performing currency this year, rose to a 13 month high. The trade balance has also stabilized this year and the prospects of increased foreign direct investment in Brazil is promising due to the credit upgrade and also because industrial output rose for the eighth straight month in Brazil, as the economy is recovering at a faster rate than anticipated. Non-government extended loans increased by 1.5% in August and total credit has grown for seven straight months in the economy, thanks to interest rate cuts and capital inflows[6]. Pressure will increase on the government of President Lula to be able to handle the flow of foreign money in a responsible manner, but as we have seen the fundamentals of output, assets, and potential growth remain strong.

Conclusion

Emotional optimism seems to be grabbing the American markets. While the dire news that often was disclosed at the start of this crisis seems to be coming in at slower rates, such trends do not signify that things are ready to get better. As we have stated, the fundamentals for the American economy just aren't there yet, and until factors such as productivity, bond defaults, credit and employment shows signs of promise, investment opportunities in the U.S. will be more scarce and risky. Furthermore, we should start talking about revival of growth only when credit stops contracting. At the current rate where credit has been declining at an annualized 9 percent, the prospects for growth do not exist (at least for real growth and not another bubble.) The monetary base (currency plus reserves) may be rising, but the money supply may be falling, if hoarding takes place, if debt appetite is low, or if credit-worthy customers cannot be found.

In contrast, the emerging economies of China and Brazil are dressing themselves in their best garments. I believe their futures are bright and they looking forward to a grand party where they will sit at the table of economic powers on a more permanent basis.

It promises to be a good ride. Enjoy, and remember that even the turtle needs to stick her neck out in order to get anywhere.

[1] Federal Reserve Statistical Release – Industrial and Capacity Utilization 9.16.09

[2] *Financial Times 9.09*

[3] www.research.stlouisfed.org

[4] The Index tracks worldwide international shipping prices of various dry bulk cargoes.

[5] *The Economist 9.09*

[6] Reuters 9.29.09