April 6, 2012

*"Communism creates shortages, capitalism creates surpluses."*
-FORBES COLUMNIST AND NOTED ECONOMIST, GARY SHILLING

**APRIL 6TH, EVA**

**Is risk-off back on?** It's that time of the month many EVA readers look forward to—an issue that I don't actually write! This week's "guest" EVA fulfills a commitment I made a few weeks ago to run an essay from either John Mauldin or Simon Hunt. The former is extremely well known to many of you but the latter is likely unfamiliar to EVA recipients, other than my recent mention. Last fall, I began to read Simon's monthly reports and I've been impressed by what I've seen. Accordingly, I thought I'd give him the nod this month.

In this edition of his monthly service, he moves around the world pretty quickly, focusing on what he believes to be key trends unfolding in China, Europe and the US, as well as their global economic implications. Many of you are also likely to notice that his outlook is frequently at odds with the far more optimistic world view held by our new business partners at GaveKal Research. However, having just spent one whirlwind day with Louis Gave while he was briefly in Bellevue (more on that in an upcoming EVA), I can tell you that their take on Europe is largely in synch.

It's no secret to any of you that I share their mutual concerns that Europe is a very heavy train headed over an extremely rickety bridge. Yet, in recent months, the still ominous developments over there have been largely drowned out by rising stock prices and generally encouraging US economic releases This week, however, the financial markets seem to have woken up to smell the espresso wafting over from Southern Europe and they suddenly don't seem to like the scent. In fact, it's reminiscent of what Seattleites used to say when the wind was blowing up from the smelters and pulp mills south of here: the aroma from Tacoma.

Another common theme is that Simon, like GaveKal, sees China undergoing a profound transition away from an energy-, commodity-, export-, and construction-intensive economy, with a heavy reliance on cheap labor. Both feel that this change has powerful implications for commodity prices and the world's previously dominant economic models. However, there is a key difference in their China outlook, involving financial deregulation, a topic I plan to cover later this month.

Finally, like GaveKal and Evergreen, Simon actually has an upbeat longer term view of the US related to what all three firms believe is one of the uber-trends of the next decade: energy (and to which I would add food and water).

With that as a lead-in, let's now consider what Simon says…

**ECONOMIC & COPPER ADVISORY SRVICES**
**ECONOMIC REPORT: MARCH 2012**

"China accounts for about 50% of all global credit creation, 26% of the world's nominal growth and 31% of its real growth, so how Chinese credit growth plays out will be a large determinant in how the global economy plays out." **Bridgewater Daily Observations, November 22, 2011**

**China and the Global Economy**

Chart 1: China Money Supply M2, % Change & 2012 Target

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Times are changing in China. The monetary and economic model that has been pursued so religiously since 1978 is changing as the leadership wrestles will the country’s deteriorating demographics and its various bubbles arising from too much credit that has grown from money being miss-priced. A firmer hand on the monetary tiller is a real prospect which will have an important influence on the global economy as the quote from Bridgewater, the world’s largest and arguably most successful hedge fund, suggests. But more about China’s political and economic transition later.

Chart 2: Central Bank Balance Sheets: Japan, US, ECB, UK, Swiss

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Meanwhile, outside China, central banks are loading their balance sheets in the hope that dollops of liquidity will not only rescue countries from insolvencies but create the foundations for growth. There are risks that these hopes will be dashed. Time has been bought and immediate bank failures averted. Collapsing money velocity rather suggests, as we will show, that economic recovery will slow before too long.

Chart 3: Global Credit Momentum is Rolling Over

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Global credit momentum leads turning points in official lead indicators by up to six months. The BCA credit cycle leading indicator is starting to roll over. As they write, the momentum of borrowing is already deeply negative in Europe, and now appears to be peaking in the US and China. The recovery is likely to slow soon and disappear if one or more of the many potential exogenous events play out.

Throughout history, there has always been an interaction between geopolitics and economics. Markets tend to brush aside these risks until they flare up in their eagerness to climb the walls of worry. In the short-term, which we define as up to one year, the main risks to us appear to be:-

- The Middle East and oil prices
- The impact of Greece either leaving the Euro Zone and/or ditching the Euro
- The political and economic impact in Europe should the Socialists win the French Presidential elections
- Rising unemployment in some European countries especially amongst the youth
- The impact of the leadership change in China, which may be none or could be multi-faceted, and
- The battle being waged between stateism and capitalism or, in short, what type of world will emerge from the global crisis.

None of these risks are easy to quantify yet they are at the heart of whether the world economy will continue to recover or go through a series of recessions until the process of deleveraging is complete. In fact, as ECRI, the US business cycle group, with a record that one does not want to bet against, states that recessions will come around more quickly than hitherto.

**Europe**

Chart 4: Spain Industrial Production & New Orders

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Spain’s economy is imploding. Industrial production fell by 6.1% in December; retail sales are falling sharply; investment is declining; officially reported home prices are down 20%, but those living in the country say it is closer to 45-50%; the banking system is effectively bust with virtually zero lending; no one – that is few – are paying their bills either government to pharmacists, for instance, or town halls or hospitals and all this before the latest round of austerity. Everyone is lying about how bad things are; official statistics are just a veneer. There is far worse to come from Spain.

Despite all the bullish talk things are little better in Italy. Retail sales are down 4% year-on-year with the fall being pretty well across small and large ticket items as Jim Walker’s Asianomics shows. Motor vehicle registrations are down 15.2% YoY, audio video appliances have fallen by 11.3% YoY and even footwear has fallen by 6.3%. Computer imports are down 48% and electrical equipment by 13.4%. Moreover, the tax authorities clamp down on unpaid taxes will only mean a further reduction in consumer spending.

Chart 5: Greece PMI

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Greece’s manufacturing sector has fallen deeper into recession. Purchasing orders declined once again with activity falling at its fastest pace in recent history with reports of difficulties accessing working capital and demands from vendors for cash payments.

The country’s PMI for manufacturing has now posted sub 50.0 readings in each of the past 30 months with the rate of deterioration accelerating. Industrial production is falling at a rate of 7% year. The bailout funds are unlikely to filter down through the economy as they are installed to save foreign banks rather than Greek’s economy.

Chart 6: Eurozone Equilibrium Exchange Rates versus US dollar

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Greece, like Spain, Portugal and France, suffer from a fundamental loss of competiveness. There is no way that Greece can earn its way back to solvency, or in fact Spain and many others, as a part of the Euro Zone. It has to exit as many others will have to. There is no chance that these governments can meet budget targets whilst their economies are contracting. Indeed, governments and banks have developed, or are developing, contingency plans for that eventuality.

There is another and murkier side to the imposition of austerity on Greek people, whether deserved or not is not the issue here: it is politics and the historic relationship between Greece and Germany. As Wolfgang Munchau  in the FT of 20th February wrote, *"Hardly a day passes by without a cartoon in the Greek press of Angela Merkel and Mr Schauble in Nazi uniforms. German MPs expressed outrage at the Greek outrage. Bild, the German mass market daily, is calling for Greece to be kicked out of the Eurozone. I shudder at the thought of an act of violence committed against Germans in Greece or Greeks in Germany. This is the kind of conflict that could easily escalate."*

In fact, there are those in Greece who see the austerity regime imposed on their country as a return to an era of total subjection when Germans marched into Greece in the WW11. Manolis Glezos is Greece’s most famous living resistance fighter. Today, he is resisting Germans once again. *"I am asking myself, I am asking you: why are the Germans treating us this way today. Do they want to take revenge because we shook down the myth of the invincible Axis? Because we stalled Hitler’s plans. Because our people perished so that their people would live"*

The other side of the argument, of course, is that Greece borrowed billions, lived off the proceeds and largely did not invest to produce the returns to repay the borrowings. Debt is debt: it is to be repaid, if not a country is insolvent. The point of these remarks is that what started as a simple, well not that simple, debt problem is morphing into political conflagration. Political harmony is the core to a successful union and that has been broken.

This lies at the very heart of the Euro Zone. Can the Mediterranean countries live in a closely knit zone with the conservative northerners? Basically the Euro Zone is a monetary union without either a fiscal or political counterpart.  The northerners are financing the wayward southerners. They are the bankers and, as most of us know, it bodes better to be co-operative with your banker.

Wolfgang Munchau in the FT of 5th March made a fundamental point. It is that parts of the German financial elite have only just realised the fact that the Euro Zone is a monetary union – and nothing else. For instance, the Target 2 balance has mirrored the current account imbalances since the outbreak of the crisis. There was no problem whilst commercial banks were able to be the intermediaries but when that became impossible post 2007, central banks had to take over that role. Now these imbalances on the Bundesbank's books, totalling some E500bn, are considered by Jens Weidmann, the bank's President, to be "an unacceptable risk". He is demanding contingent access to Greek and Spanish property and other assets to a value of E500bn in case the Euro Zone should collapse.

This demand tells us two things. First, that the Bundesbank now believes that there is a risk of a Euro Zone break-up; and, second, that Germany, or parts of its elite establishment, now does not want a monetary union but would prefer a looser single currency regime. However, given the widespread of competiveness between countries in the zone, this development rather suggests that the Euro Zone will be restructured. The northern members plus France will coalesce around a D Mark with the Euro being the currency of the other existing members. The Euro will then fall sharply.

This is the probable future structure of the Euro Zone but it could take a few years for that outcome to be realised.

What could put a spanner in the works is if the socialists should win the Presidential elections. Then all three pillars of France's governing structure will be socialist. The odds are then that there will be a policy of spend, spend and spend. How will such a policy will be reconciled with Germany and indeed Greece, Italy, Spain, Portugal and Ireland who are being forced to pursue austere budgets in return for financial assistance, is difficult to foresee, but it will probably mean that these countries will take a leaf out of France's book. That outcome will be wholly unacceptable to Germany who could then be the country that exits together with its northern neighbours, leaving France out in the cold.  Thus, the outcome of the French elections will be decisive for the future of the Euro Zone. No wonder Mrs Merkel has indicated that she will support her French colleague in his electioneering.

A disturbing trend for future stability in Europe is, once again, demographics. There are two main issues that we will focus on. They are Europe's aging population and its high level of unemployed.

For this exercise we have focussed on France, Germany, Italy, Spain, the UK and Greece and for the years 2010, 2015, 2020 and 2025. The total changes for these countries are set out below.

Population Trends in millions

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Within this group of countries the worst in respect of the number of retirees is Germany. The percentage of 65+ rises from 21.3% in 2010 to 25.4% in 2020 and 28.3% five years later. The best is actually the UK having 16.7% last year rising to only 20.1% in 2025. Unless, this group of countries can sharply accelerate its level of productivity, the group's trend growth rate must decline and in some cases very sharply.

Graph 1: Euro Area & EU27 unemployment Rates

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What is worrying for the longer term is not just the rising and high level of unemployment, but the extraordinarily high rates amongst those under 25 years. As of January this year total unemployment in the Euro Area was 10.7% versus 10.0% a year ago. However, youth unemployment is now 19.6%, or 3.314 million for the region. Some countries have very high levels of youth unemployment. Spain is at 49.9%; Greece is over 48%; Italy 31%; Portugal 35.1% and so on. This is a cause for social unrest which can spread beyond national borders. How do these governments address the issue under the austerity regimes that have been imposed on them?

Both an aging population and very high levels of unemployment amongst the youth of these countries are the soft bellies for Europe. They will be the source of future serious problems unless confronted soon.

**The US on Debt-on-Debt**

Chart 7: ECRI US Coincident Index

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ECRI are students of the business cycle and do not use econometric models but a series of robust leading indices which have correctly anticipated both recessions and recoveries since Dr Moore funded the group more than 50 years ago. Therefore, what they say should be listened to.

Chart 8: On the Edge

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To paraphrase this is what ECRI are saying. Year-on-Year GDP growth peaked in Q3 2010, fell to Q2 2011 and essentially since then has been flat-lined. Personal disposable income has followed a similar pattern. Year-on-Year industrial production in January was at a 22 month low. Their coincident indicator is now at a 21 month low where every time in the last 50 years it has hit this point a recession has followed. The Fed has injected huge sums of liquidity into the system but money velocity is at a record low in the USA and close to that in both Europe and China. We feel better because that money has to go somewhere so it goes into commodities, the stock market and in some countries/cities real estate.

This summation fits our view. The world economy is only experiencing a short and fitful recovery that will peter out in the second half of the year or early in 2013. This is an implicit part of our rolling recession scenario that will continue until deleveraging has run its course.

Deleveraging also means that the world will experience a new and perhaps more damaging credit crisis when holders of assets, whether equities or commodities, will want cash. This development should start either later this year or in 2013 with prices in a sharply downward trend until around 2016.

Piling more debt on an existing pile of debt only buys time; it does not confront the problem that someone must carry that debt. This scenario will continue until around 2016-2018 after which the world should enter into a long period of slower but sustainable growth, a period when it will be equity and not debt that will be the financial mechanism for the world to grow.

The final issue is the type of world that will eventually emerge from this crisis. At present, most developed countries are seeing the state becoming a larger stakeholder in the economy. This is especially noticeable in the USA. Capitalism is being overtaken by stateism. This is a worrying development because history shows that government involvement is far less productive and more destructive because the private sector is not allowed to compete. Whilst the USA and some other countries are going down this route, China is trying to go down the route that made America the great country it is or was(?).

Our sense is that so great will be the financial crisis somewhere post 2012 that America and others will discard the policy of creeping socialism and allow market forces to clear the system of rotten assets and allow the private sector to propel growth forward. The process of creative destruction will be led by new technologies and innovative practices, anything from nanotechnology to space tourism or fuel cell cars. But first, there will be a yawning bridge to be crossed.

Simon Hunt

(To learn more about Simon's excellent service, please **click on this link.)**

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