

February 1, 2013

"It is typical of government price-fixing schemes that they escape one undesired consequence only by plunging into another and usually worse one."

-HENRY HAZLITT, FROM HIS CLASSIC BOOK, ECONOMICS IN ONE LESSON.

POINTS TO PONDER

1. There are several reasons why Canada appears to be one of the safest global venues for bond investors. Among those is how modest its overall debt levels are relative to the rest of the "rich" (but increasingly in-hock) world. (See *Figure 1*)

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2. Another supportive factor for the Canadian bond market is that inflation is in a decided downward trend. (See *Figure 2*)

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3. AAA-rated countries are becoming as rare as sports stars who have never used performance-enhancing drugs. AAA-rated debt now represents just over 10% of all sovereign debt issuance vs. 50% as recently as 2010 (before the US lost its AAA S&P rating). Based on the most recent congressional budget antics, further US downgrades seem highly probable. Accordingly, Canada stands out as a rare country that boasts a solid AAA rating with no downgrade threats looming. (See *Figure 3*)

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4. Morgan Stanley strategist Rich Tang makes the extremely significant point that with the Fed buying \$1 trillion of bonds this year (with pseudo funds, of course), and only \$1.3 trillion of total investment-grade public and private sector debt issuance, there isn't much supply to go around. Thus, it is hard to visualize a major bear market in bonds in 2013, as long as the Fed sticks to its money creation plans.

5. In a recent white paper, Bain and Co. states that total global financial assets (mostly debt instruments) are now \$600 trillion, three times the 1992 level. They are also 10 times the total of global goods and services (GDP). Bain predicts paper assets will continue inflating to \$900 trillion by 2020, further dwarfing the growth in actual economic activity.

6. Economic forecasting giant ISI has noted the recurring tendency since the Great Recession ended for the US economy to weaken in the summer and then rebound in the fourth quarter, with the growth spurt continuing into the first few months of the next year. This may be why the stock market has encountered mild to severe turbulence in the spring and summer months in each of the past three years. 2013 may well continue to follow that pattern, notwithstanding a weak Q4 that was negatively impacted by a cliff dive in government spending. (See *Figure 4*)

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7. There have been a number of upbeat datapoints on the US economy over the last two months. Yet, the most recent Empire State, Philadelphia, and Richmond Fed surveys were all unambiguously weak. David Rosenberg, economist par excellence, referring to the Empire State

report, stated: “The underlying details were squarely awful.”

8. Financial markets have been euphoric based on the latest budgetary can-kick by Congress and the promise of nearly unlimited money proliferation by central banks. Yet, the IMF recently sliced its global growth estimate for 2013 and put the odds of a euro recession at 80% (this author thinks the eurozone is already in another downturn).

9. Based on the Fed’s unprecedented money fabrication, long-term inflation concerns are understandable. On a near-term basis, though, upward price pressures are muted and, in the case of the core producer price index (PPI), actually receding. (See *Figure 5*)

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10. Real interest rates (i.e., adjusted for inflation) are the lowest they have been since the easy money days of the mid-1970s. Those negative real yields set the stage for the double-digit inflation outbreak a few years later. There are certainly major differences today vis-à-vis the 1970s but it’s highly likely that current Fed policies will eventually create their own set of problems. (See *Figure 6*)

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11. Gold is an asset class in need of a catalyst. It may receive one from the growing coverage of

the repatriation drive by key central banks of their overseas bullion. The most significant move in this regard is the decision by Germany's Bundesbank to pull its gold from the NY Fed, where nearly half of its hoard is stashed. Should some repositories come up short in returning bullion, it would likely accelerate repatriation by other central banks, with rising gold prices a high probability.

12. In a clear indication of easing fears over a banking crisis in Europe, US money funds have now added exposure to Eurozone financial issuers for five straight months. However, on a negative note, French car sales in 2012 hit their lowest point in 15 years, consistent with other reports indicating an intensifying recession in that critical country.

13. As in the US, there seems to be a striking disconnect between ebullient European stock markets and economic reality. In fact, the dichotomy is even more extreme with Italy and Spain experiencing a 7% plunge in industrial production year-over-year in November.

14. A recent key EVA theme has been the relative attractiveness of "dim sum" bonds (debt issued by multi-national companies in China's currency, the renminbi). In addition to potential currency appreciation relative to the US dollar, yields are higher than in most developed countries. Thus far in 2013, 84% of dim sum issuers carry investment-grade ratings.

15. Last year, for the first time ever, China's working age population shrank. As a result of its famous (some would say infamous) one-child policy, this trend is poised to gain momentum in the coming decades. It will also make it much harder, if not impossible, for China to return to its former double-digit economic growth. (See *Figure 7*)

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The LBO market. EVA readers, being the notably market savvy bunch they are, no doubt associate "LBO" with leveraged buyout. That catchy abbreviation has become somewhat antiquated in recent years. It has been eclipsed by a dizzying array of acronyms like TARP, PPIP, QE (1, 2, and 3), LTRO, OMT, and a host of others that central banks have concocted in their attempts to deal with the global financial crisis and its aftermath.

Yet, as we have seen with the recent stock and bond price action in Dell, LBOs are still very much a source of potential reward for shareholders—and of latent risk for bondholders. While Dell's common stock is up around 20% over the past few weeks, its longdated bonds have produced nearly the inverse result.

With interest rates still lower than Congress' approval rating, and junk debt lenders increasingly

willing to finance any deal that can fog a mirror (or a prospectus), the environment is once again highly conducive for LBOs to come back in vogue. However, that's not the LBO market I was referring to above.

Rather, I would postulate that, presently, it also stands for "least bad option." In my mind, this is what stocks have become in a world where the Fed and its cohorts in most of the world's leading economies have made almost everything else as appetizing as sashimi that has been left out in the noonday sun during the recent Aussie heat wave.

This is the time of the year when my wife and I have decamped to Hawaii for our usual mid-winter vacation. We've been doing this for nigh on 30 years, with just a couple of exceptions (like 2009 when financial markets were at DEFCON 3). Coincidentally, this is also when *Barron's* runs its annual Roundtable series featuring a three-edition interview with 10, or so, of the world's most celebrated money managers.

Some of them, such as Felix Zuluaf, have been on the panel for as long as I can recall. Over the years, Felix in particular has made a number of highly prescient "big picture" calls like warning about Japan's epic stock and real estate bubbles before they blew apart. He also correctly foresaw the mayhem the collapse in the overheated US housing market would cause back in early 2008.

Suffice it to say, he once again has intense concerns, these days about the price ultimately to be paid for the "Print, Baby, Print!" mind-set of the Fed and its peers. Here is an excerpt from his interview in the January 21st issue: "The world economy isn't growing enough to keep structural problems under control much less fix them. Therefore, nations are trying to grab more of the pie by devaluing their currencies. The US started this nonsense, and the Fed's money-printing has made the dollar a weak currency."

He went on to observe: "People believe the risk in the market is low, because volatility indexes are low. Perceived risk in March 2009 was very high (my note: when the VIX, or volatility index was at record-breaking levels), but the market risk was low. Right now, it is just the opposite, and that mismatch could persist. But we should be aware we are operating in a high-risk environment."

A few moments earlier in the same session, Bill Gross, the still-reigning King of Bonds, who is also a member of the Roundtable, chimed in: "All assets are artificially 'bubbled.' The trick is to figure out which are less bubbled..."

In other words, the search is on right now among the best and the brightest to find the least bad option during a time of the Fed's Great Levitation. It's a bit like trying to quaff the last few glasses of champagne on the Titanic.

Most of the Roundtable panel members admitted that eventually there will be another "Great," as in the Great Unwind—when the bill comes due for all the central banks' hyper-largesse. But, as mentioned above, this multi-trillion dollar asset floatation can continue for a while longer. And professional money managers are paid to try to make as much as they can for clients until the music stops—as it always does. Which leads me to a thought that has been rolling around in my mind lately...

Why the investment gods must be crazy. Any sentient creature, looking back at the tech bubble of the late 1990s, or the lending mania of the mid-2000s, would conclude that the graffiti

was all over the subway walls (and tenement halls—if you get that one you are seriously dating yourself). Yet, millions of investors, as well as countless allegedly “professional” investors, managed to keep pumping helium into the balloon right up until the explosive end. How could that happen? To answer that, we need to consider a phenomenon that could plausibly be called “the tyranny of the benchmark.”

Markets these days are largely driven by institutional investors who are entrusted, for better or worse, with assets that frequently belong to normal folks through their 401(k) or direct mutual fund share ownership. The underlying investor has a well-documented tendency to put money into areas that have been rising over the past few years.

To stay up with their benchmarks, and not get fired for lagging, professional investors usually feel compelled to buy even if they believe prices are inflated. Invariably, the asset class that has been running gains even more momentum as the performance-chasing money comes flooding in. This creates even more upward pressure and yet more forced buying. The cycle perpetuates itself until something comes along to serve as the pin prick. Then the air goes out even faster than it went in.

Thus, highly sophisticated investors, like those on the Barron's Roundtable, may think and talk bearishly but act bullishly—not because they want to but because they feel they have to. When a mentality forms of “you’ve got to keep up with it”—whether the “it” is the market itself or a sector, like tech—it takes a very brave man or woman to resist the pressure to get in on the action. And the end to the festivities is almost always close at hand when even bears begin to behave like bulls.

Evergreen’s partner, Louis Gave, attended the Dick Strong conference in Vail last week. Similar to Barron’s collection of brainpower, the Strong event brings together some of the most muscular investment (and non-investment) minds around. Last year, Louis noted that this group was “all beared up.” He correctly postulated this would lead to a consensus-confounding rally.

This year, though, the tone was much more upbeat. To contrarians like Louis and me, that is something of a red flag. Similarly, the World Economic Forum in Davos, where the Grand Poohbahs of the global financial system convene each year, just concluded. From all reports, it amounted to a self-congratulatory victory lap for the planet’s central bankers. Last year, they were in panic mode. This extreme mood swing, from despondent to euphoric, further raises my concern level.

It’s also a bit bizarre that the stock market, along with its cheerleaders, is convinced the US economy is accelerating. If this were really true, why does the Fed feel it must produce and inject a trillion dollars a year into the banking system? Clearly, either the market or the Fed has it very wrong.

The big news this week was the revelation that the US economy actually shrank in the fourth quarter. Given the prevailing bullish mind-set, this shocker was quickly dismissed. The reality is that the third quarter was artificially inflated by an almost inexplicable surge in government spending (“almost”, except that it was right before the election). The fourth quarter brought a reversal of this, so if you put the two together you get an economy growing at the lackluster 1.5% to 2% rate that has characterized most of this recovery.

But this begs the question I’ve asked before: Is this the best the US economy can do, more than three years after the recession’s end, despite trillion dollar deficit spending and an equivalent

amount of Fed money manufacturing? Yes, I realize, the prevailing wisdom was perfectly captured by one pundit on CNBC this week, who called this “the classic ‘don’t fight it’ market.” In other words, the Fed’s got our backs.

This raises yet another question in my admittedly perhaps too skeptical mind: Based on the Fed’s history over the last 12 years of serial bubble blowing, followed by spectacular blowups, why should that make anyone feel better?

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