

May 11, 2012

"They are going to have to do something in Spain's case. This is a big economy and the banks are holed below the water line."

-SIMON TILFORD, CHIEF ECONOMIST AT THE CENTER FOR EUROPEAN REFORM

MAY 11TH, EVA

What price arrogance? An article of faith on the part of central bankers, along with most of the academic community, is that there really is no such investment phenomenon which less cerebral types refer to as a "bubble." Their reasoning is that since they are extremely erudite folks they know that markets are impeccably efficient. Ergo, bubbles are, by definition, impossible.

Yet, as most of humanity has painfully learned, central bankers are thoroughly fallible creatures. Their errors of omission and commission have carried a multi-trillion dollar price tag for the planet earth.

In many ways, what Europe is going through right now is payback for a bubble that was very much a creation of its intellectual elite, including its central bankers. Establishing a common currency with radically different cultures, economies, and financial systems triggered a long chain reaction that culminated in the detonation we are witnessing today.

One example of that was the convergence in interest rates between southern European countries, also known as the "Club Med," and those from more financially prudent nations such as Germany. Artificially low interest rates produced both a real estate boom and a consumption binge in the Club that led to years of pseudo-prosperity. Even more harmful was the related buildup in what have now clearly become unsupportable debt burdens.

The good news is that many other countries have gone through the aftermath of bubble implosions, or at least chronically ill-advised policies, and, after a few years of pain, have gotten back on the road to solvency and growth. The bad news is that the happy ending doesn't always play out, with Japan still ensnared in a classic debt trap.

In this week's guest EVA, Charles Gave, of GaveKal Research, uses his prodigious combination of intellectual prowess and clear writing skills to explain how to cope with the wages of "bad" bubbles. (Believe it or not, there are "good" bubbles, or at least "less bad" bubbles, a distinction he illustrates below.) As you will read, Charles is primarily interested in containing the fallout from the bursting of bad bubbles, which typically involve the banking system and real estate. The urgent case in point right now is Spain, which does appear to be careening toward a modern-day Depression.

Charles asserts, as do many others, that a dramatic currency devaluation is an essential element in the healing process by creating a trade surplus. However, he also notes the often overlooked, yet vital, aspect of pulling in foreign capital to buy cheap assets (like empty villas on the Costa del Sol). In addition to the examples he cites, the experience of Iceland further validates his thesis where a 60% currency plunge is reviving its economy with unemployment falling to a very un-European like 6.7%.

Sadly, that's a relief valve Spain is lacking, at least for now. As you will soon read, it's hard to believe the Spanish people will put up with this much longer.

How to Deal with Bad Bubbles

By Charles Gave

As our regular readers know, there are good bubbles and there are bad ones. By our definition, a "good bubble" occurs in productive assets, such as railways or internet lines, and is financed by equity. A "bad bubble" takes place in unproductive assets (tulips, land, government bonds...) and is financed by bank credit.

Not all bubbles are "bad"- but Spain's is

A bad bubble is what we have today in Spain. Understanding this basic reality must be understood if we hope to deal with the situation. The bursting of a bad bubble usually leaves the financial and economic system with this:

- Overvalued assets, usually with little or no cash flow, against which a massive amount of credit has been extended.
- An overextended banking system. As we all know, banks can lend in theory up to 12 times their net capital, but in practice they tend to lend much more, especially in "easy money" periods like the past decade (see Lehman just before its collapse).
- The combination of falling asset prices and an overextended banking system leads to the possibility of a "debt deflation" a la Irving Fisher (see *The Debt-Deflation Theory of Great Depressions*). This is a massive margin call on the banking system, itself leading to a relentless spiral of falling asset prices through forced liquidations, regardless of prices.

Debt deflation occurs with a remarkable regularity in financial history. In my own career, I have seen the scenario unfolding in the UK in 1974, in Japan in 1990, in Sweden in 1992, in Asia in 1997, in Iceland in 2008 and now in Ireland, Spain, Portugal, France, etc. Historically, there have been two ways of dealing with these unfortunate events. Authorities can either protect the entrepreneurs (or owners of the assets), at the expense of the bankers, or they can protect the bankers at the expense of the entrepreneurs. The end results are strikingly different.

The first part of this report presents a case study of a country which did protect its entrepreneurs, and I have chosen South Korea after the Asian Financial Crisis. I could have chosen Sweden after 1992 or Canada after 1994 or many others, but the path towards a return to financial sanity is always the same. It starts with the realization that the name of the game is to stop the death-spiral of assets. Historically, the best way to achieve such a result has been to move the exchange rate to a grotesquely undervalued level. This is because:

Historically there are two ways of dealing with debt deflation: either protect the entrepreneurs, or protect the bankers

1. An undervalued exchange rate makes the assets in the country look very cheap on an international basis. This leads to capital inflows which almost always succeed in stabilizing the asset prices.

2. Low interest rates are part and parcel of the undervalued exchange rate. Capital inflows allow

the central bank to collapse short rates, which makes it much easier to carry leverage positions.

3. The undervalued exchange rate leads to a huge turnaround in the trade position of the country, which typically moves from a current account deficit to a current account surplus. It should be noted that this improvement may take a long time (see the UK today).

It is very easy to monitor signs of success in such a policy: the stock market starts to outperform global equities, with financials leading the way. It also outperforms US Treasuries, the world's most liquid risk-free asset. Credit spreads start to fall and if some supply side measures have been taken at the same time (privatizations, deregulations etc.), the exchange rate starts going up, with a lag.

A crushing devaluation put Korea on the path to recovery

These patterns are very clear in the South Korea case. From 1996 to end 1997, the KRW moved from two sigma overvalued to two sigma undervalued, quite a trip in such a short period of time:

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As could be expected, this massive transfer of wealth from local rentiers (bond holders, debt holders, civil servants, real estate owners) to local entrepreneurs led to a recovery in the stock market:

Equities began to outperform USTs

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With asset prices first stabilizing and then going up, financials started to outperform in a rising market, and the broad market outperformed other global benchmarks:

Korean banks led the way

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In Korea's case, the trade balance moved almost immediately back to a surplus, which then allowed for the exchange rate to recover—and at the same time for M1 to expand under the effects of the capital inflows:

Money supply expanded

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This is the only successful way of dealing with an overleveraged system. One must not pay any attention to the banks, except to nationalize them if needed, taking their shareholders to zero and sending a few of the managers to jail when justified (which is generally very well received by the population). The tool of adjustment is the exchange rate and it is through the exchange rate that the transfer of wealth from the rentiers is organized in favor of the entrepreneurs. To a large extent this approach is currently being followed by the US and the UK.

The other option is to protect the banks - we saw how well this worked in Japan

And then there is the Japanese way of dealing with the issue, where the ultimate goal is to protect the bankers against their own stupidity, at the expense of everybody else and especially the entrepreneurs. This always takes place when the bankers dominate or control the political system and ask to be "protected". Needless to say, this is the policy currently followed in Europe.

Moreover, when zombie banks are kept alive, it is ultimately through the support of the state. If asset prices do not stop falling, the debt that is being transferred to the state quickly becomes so big that the economy moves ex-growth in a classic debt trap (see How The World Works). This eventually leads to the bankruptcy of said state. And since the bailed-out banks have generally exchanged their ownership of real estate for bonds issued by a government, they are not saved in the end either.

The Spanish case

Now let's have a look at Spain as an almost textbook case of what should not be done. **First question: Is the Spanish Exchange rate massively undervalued?** The answer is a resounding no. This means foreigners will not buy assets in Spain, and the decline in asset prices will continue.

Spain is trying to raise itself out of a debt trap while carrying the heavy burden of an expensive currency

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Once we have a negative answer to this first, crucial question, the country tends to fail on almost every other health-check as well.

• **Is the Spanish stock market starting to outperform the US bond index?** Answer: you must be joking! The Spanish stock market is still falling like a stone (see chart below).

• **Are the financials at last going up, as a sign that asset prices are stabilizing and have found a bottom?** No. They are hovering over new lows, while Spanish CDSs are near new highs, a sure sign that the markets are starting to be worried about the Spanish government's ability to absorb all this doubtful private-sector debt.

Spain's stock market continues to fall like a stone, and its banks are trading as low as ever

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• **Is the Spanish economy starting to miraculously recover?** Not one bit. We are entering into a new recession, which everybody is telling me is going to be "mild" (as in Greece, I suppose). Nominal GDP is heading for a contraction, which makes the debt trap even worse.

The nominal growth rate is lower than the cost of long-term financing

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Conclusion

The probability is that the Spanish economy is moving full steam ahead into a deflation/depression. To illustrate this point, we pushed forward the Japanese market by twenty years to compare it with the Spanish market:

Spain would appear to be retracing Japan's footsteps from 20 years ago

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When the Greek crisis started, we argued, tongue in cheek, that the Europeans had three options:

It is hard to imagine the bond markets can withstand more bad news on Europe's fiscal situation

1. **Dismantle the Euro**, the only solution.

2. **Move to full federalism**, which would not work anyway, the potentially bad EMU government debt being far too big to be dealt with even for Germany and its savings.

3. **Fudge**. This was going to be the most likely outcome and fudge they have, moving from one bizarre scheme to another: e.g., from a fund to bail out bankrupt countries financed by those same countries, to a LTRO plans whereby the ECB lends bankrupt banks money to bail out bankrupt countries. Of course, none of these schemes have any more chance of working than similar ones did for Japan.

It seems obvious that we are getting closer and closer to the end of the financial Frankenstein known as the euro. The French elections may be the last nail in the coffin. If elected, I cannot see Francois Hollande reducing the salaries of the civil servants and/or cutting government expenditures while his troops are campaigning on his promises to hire more civil servants, as Mr. Mitterrand did in 1981.

With Spain walking into a debt trap and France heading towards increased deficit spending, it is hard to imagine European bond markets can withstand much more of this euro experiment.

Correction: *A very observant EVA reader caught an error in last week's issue. I had written that seven of the seventeen eurozone countries that share the euro are in recession, including the UK. In reality, the UK has its own currency and is not part of the actual eurozone but it is a member of the European Union. In that more inclusive group, eleven of the twenty-seven countries are now suffering economic contractions.*

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