An Alternative(s) View

In the current volatility, and don’t expect this to be a linear race to the bottom, there will be significant countertrend rallies, its easy to lose sight of the big picture.

– the boom experienced from 2002-2007 was fed by low interest rates, rising housing markets, and unprecedented credit creation on the back of rising collateral value.

– a tangible measure of economic well being should be the real value of GDP less debt. GDP is calculated off expenditure which can be expanded simply by the assumption of more debt. On these measures, 2002-2007 might not be regarded as such an unmitigated success after all.

– the problem was not 2008 but the period 2002-2007 during which there was excessive credit creation.

– real GDP growth less credit is a not only a less volatile quantity, it turns out to be a less exuberant one. The problem that the world faces is that real and nominal GDP must now revert to mean through a process of debt deleveraging. This is problematic and painful.

– credit creation could not be reversed without acute withdrawal symptoms. As a result there have been a series of debt transfers and transformations: TARP, TALF, HAMP, QE, various ad hoc bailouts et al, to rotationally transfer debt from corporates, households and the private sector to government. I preemptively describe this as rotational because there is the possibility of the converse transfer, already beginning with the commercial banks.

– debt transfers notwithstanding, the total stock of debt is constant but for repayment of coupon and principal. Or

reorganization. The paying down of this debt has to come out of output. Plainly, you cannot pay down debt without economic growth and you cannot pay it down faster than allowed by the level of economic growth.

– the debt created before 2007 has to be paid down through economic growth. 2008 was merely a reaction to the realization that lending standards and quality of collateral were deficient and that the ability of the economy to repay its debt obligations was not a foregone conclusion. All the transfers and transforms following 2007 was merely a reaction to the reaction following the realization. Noise. Loud and ominous.

– collateral damage from the 2008 event takes two main forms. The first is that credit creation and distribution channels have been and remain to a certain extent, impaired. The second is that much of the growth pre 2008 would be negative or infeasible without the scale and cost (arguably mispriced by the distorting impact of unilateral interest rate determination by the Fed) of credit prevailing at the time.

– the above provides a framework for estimating trend growth and thus the level of feasible output at each date in the future ex credit.

– in addition it implies that any retrenchment in credit will impact the traditional measures of real GDP growth (mostly negatively). The credit retrenchment can occur quickly (with painful consequences) or slowly (with other consequences).

The above is an incomplete but hopefully useful summary of the landscape before us. The investment implications are many and provide ample opportunities not only to avoid loss but to make money. The converse, unfortunately is also true.

– generally, debt will attempt to be transferred from constituency to constituency. It went first from banks and private hands to government. There it is being transformed

into government debt which was under QE2 transferred to the Fed. It is now being transferred back to commercial banks (in a form of QE3 and thus back into private hands. Rotational trading and asset allocation can capture the price volatility that follows in the cash, futures, swap and repo markets, not to mention the Muni and ABS markets. .

– different countries are net creditors / net debtors (on a stock basis) and different countries are net borrowers / lenders (on a flow basis.) Sovereign local and hard currency debt will price demand and supply, credit worthiness, FX and inflation differentially affording relative value opportunities.

– private businesses with localized or global operations will have differential fortunes arising from the differential fortunes of the respective economies. These themes will drive equity and credit long short relative value strategies.

– credit retrenchment means only one thing: further distressed companies (not to mention a number of sovereigns). The easy credit years bore and sustained businesses which under tighter credit conditions would struggle to exist or could not exist. Expect delinquencies and default rates to increase in the coming years. This will result in fertile ground for the distressed debt investor.

While there will be ample opportunities for profit in the current and future reality the opportunity for loss is equally great. Naïve strategies will suffer. Traditional notions of value, of momentum, and of fundamentals, will not suffice. While there is nothing new under the sun, the current environment is not one we have encountered for nearly a century. And crises of similar magnitude and nature occurred before the advent of derivatives of the current complexity. It is therefore important for the investor to be at the forefront of financial engineering while not being wedded to established wisdoms and methods.