Strategy Update Aug 2011

You may recall my view in 1Q that the US economy was already in recession at the time.

The rationale for this was that with housing prices and mortgage rates falling and residential rents stagnant, the price deflator for calculating GDP was underestimating inflation and thus overestimating real GDP growth. The risk to the reported GDP number was that if the shelter element in the deflator rose, GDP growth would be hit. Rents are rising as households switch from home ownership and mortgages to renting. I expect this trend to continue and that for a constant level of nominal GDP, this will lead to negative or at best diminished real growth numbers.

Putting aside the technicalities of calculating real GDP, ancillary evidence points to a further slowdown.

The economy is a massive feedback mechanism hence the intractability of predicting its pace and direction.

For the weakness in the economy, the housing market is as good a starting point as any. Housing has for a long time provided the collateral for consumer loans that fueled consumption. Absent a recovery in housing, there will be no recovery in consumption. That part of the economy servicing domestic demand will continue to be in recession. A recovery in housing requires a recovery in employment and the availability of mortgage credit. Absent a recovery in employment, house prices will stagnate at best. The feedback loop is of course that absent a recovery in corporate profits, in no small part reliant on domestic consumption, there is no recovery in employment. The trend in mergers is a negative factor for employment even as it improves corporate profitability.

Government is severely constrained and will likely not be able to provide fiscal stimulus without nasty side effects.

This leaves exports where a weakening USD is a positive factor. Be that as it may, headwinds remain in the form of Europe which is in similar shape and has to export, Japan, historically a major export economy, and China, the current export champion of the world. Not everyone can be a net exporter. Neither do they need to be. The lines we draw to separate companies by country of listing is arbitrary and in times like these, not useful.

To be clear, there has been a raging bull market throughout all the turbulence coming from the Japan Quake, Middle East unrest, European sovereign debt crisis, emerging market inflation, et al, but this bull market has been limited to developed world exporters. Conversely there has been a raging bear market in emerging market exporters. Therefore, in the past year, it has been profitable to invest in companies whose source of revenues or marginal source of revenues came from the emerging markets while shorting companies whose source of revenues came from the wounded economies of the developed world. This strategy worked because there was a clear decoupling between emerging and developed economies. It was possible, with appropriate stock picking, to run a profitable net long book in the face of falling equity markets. This may change.

The efforts to debase currency, and concomitantly debt, by the Western central banks have had collateral effects on emerging market inflation. Efforts by emerging market governments to deal with these inflationary pressures have inflated cost of capital and diminished credit availability. The impact on their exporters is doubly hard when coupled with the difficult operating environment. The impact on domestic businesses is also negative. The credit controls also drive credit underground (read off-balance sheet) to where surveillance and governance can be poor. The net effect is to render the emerging markets an even more treacherous place to invest. Further, these efforts at keeping hot capital at bay are likely to choke off domestic consumption in emerging markets. This would reverse or hinder the positive trend in developed market exporters.

Where once there were clearly defined long opportunities and short opportunities, one struggles to find good long ideas. The luxury stocks trend is likely to continue, but the dispersion of returns within the sector are likely to rise as valuations become stretched and some companies experience brand fatigue. The market is very clearly a trading market where investors are playing chicken, seeking to flinch just before the market turns.

A word about US treasuries and a potential QE3. With sentiment turning as negative as it is, it is impractical for the US Fed to announce a QE3. If established, it is more likely to be operated in stealth or under the guise of something else. Financial oppression in the form of Basel 3 and other capital requirements already coerce commercial banks to fund the government (by buying treasuries) instead of private enterprise. This has a nasty side effect in that employment grows most in SMEs while the government is retrenching. For the treasury market, however, it provides a large bloc buyer with little else to do except to invest in the securities of an issuer whose securities carry a zero risk capital weighting, yet isn’t particularly credit worthy.