CLSA
ASIA-PACIFIC MARKETS

Solid Ground

Global outlook

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Global
Macro strategy

It's *not* the economy, stupid

Relative to bonds, US equities are cheaper now than at any time in the past 50 years. Bears justify this as being due to a probable "double dip" recession. But unless that double dip produces a 60%-plus decline in earnings, equities are cheap. Such a collapse could not be ruled out during a debt deflation, but bank credit and broad money in the USA have finally started to grow. At these relative valuations, investors have consistently made material positive returns in every period since the late 1950s. Yield compression alone could push US equities up more than 30% and if inflation concerns increase, gains could well exceed this.

Equity earnings yield relative to bonds at 1955 level

- Comparing bond and equity yields can be dangerous for the long-term investor but has been very profitable for those with a short-term focus.
- Investors have consistently made good profits at the current yield gaps and ratios since 1958.
- Yield gaps and ratios suggest equities valuations are pricing in earnings and dividend declines of over 60%, yet a decline of such magnitude is very unlikely.

US bank credit and broad money are growing

- US bank credit and money have been growing at around 6% annualised since June.
- Growth in the commercial-paper market suggests demand for credit is returning.
- The deleveraging of America may be ending, while equities are pricing in deflation.

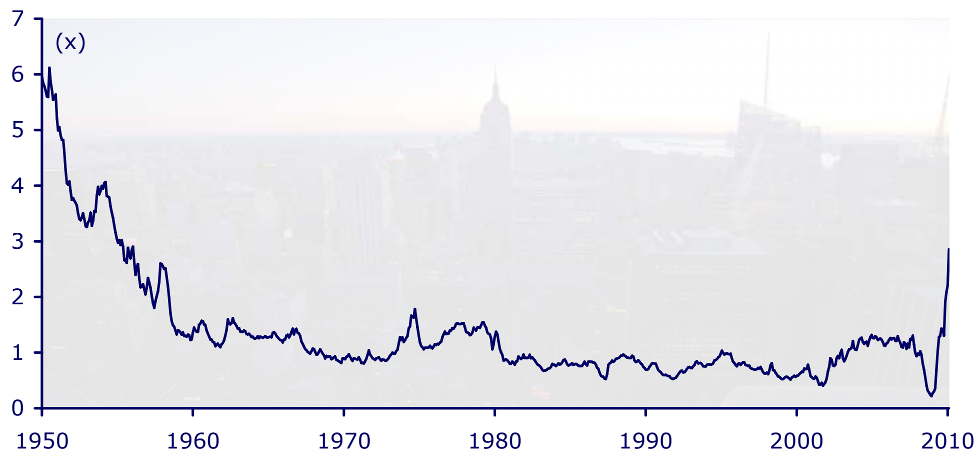
Large corporate cashflow on the verge of mobilisation

- Institutional dynamics ensure that deposit accumulation in companies must end.
- Liquid corporate balances have reached US$2.4tn and annual cashflow US$1.7tn.
- As companies are not paying down debt, this liquidity will be used in ways that are positive for economic growth and/or equity prices.

Bonds are entering a bear market that will last a generation

- For the third time since the 1850s, 30-year rolling real bond returns are near equity returns, and on both previous occasions multidecade bond bear markets followed.
- US bonds will be destroyed by the retirement of the baby boom generation and a move to independent monetary policies in emerging markets.
- Equity prices can continue to rise in the early stages of a bond bear market and should not stop rising until the 10-year Treasury yield exceeds 5%.
- As in 1974, equity investors have an opportunity to make large returns in a bond bear market and a secular bear market in equities.

Earnings yield back at a level not seen since the late 1950s



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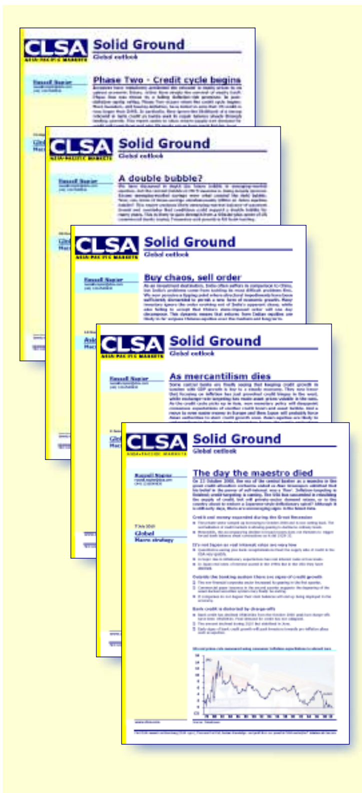

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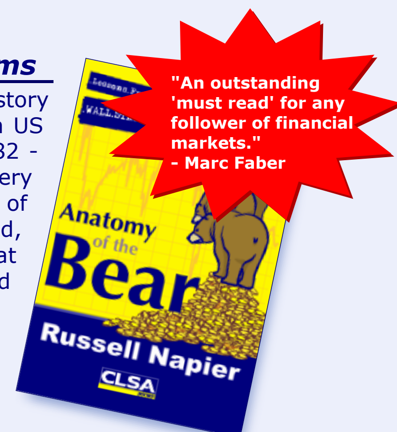
About Russell Napier

Russell Napier is a consultant with CLSA, writing on issues affecting global equity markets. He worked as an investment manager at Baillie Gifford in Edinburgh, before moving to Foreign & Colonial Emerging Markets in London. In May 1995, Russell became Asian equity strategist at CLSA in Hong Kong. He was ranked No. 1 for Asian strategy in both the *Asiamoney* and Institutional Investor polls in 1997, 1998 and 1999. Since 1999 he has worked as a consultant for CLSA. Russell has developed and runs a course called A Practical History of Financial Markets. The course is aimed at fund managers and involves teachers with some 150 years of experience communicating the key lessons in financial history in just two days (www.sifeco.org). Russell's book *Anatomy of the Bear* was named as an investment read of the year for 2006 in the *FT*, and was republished in 2007 and 2009.

Anatomy of the Bear:
Lessons from Wall Street's Four Great Bottoms

Russell Napier's acclaimed book examines financial market history as a guide to the future. Looking at the four occasions when US equities were most undervalued - 1921, 1932, 1949 and 1982 - Napier set out to answer key questions by analysing every article that appeared in *The Wall Street Journal* either side of the market bottom. Through the 70,000 articles he examined, one begins to understand the features pointing to a great buying opportunity arising. Napier offers investors a field guide to making the best financial provisions for the future



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It's *not* the economy, stupid

Compared to bonds, equities are currently extremely cheap

Whether judged on dividends or earnings yields, equities are currently at valuations relative to bonds not seen since the yield gap became the inverse-yield gap. Such valuations are pricing in a pre-WWII dynamic, when central banks were chained to the gold standard and there was no monetary medicine for deflation. Today there are no fetters on the Federal Reserve and the structure of monetary policy remains entirely different from that of the prewar era. There are very large gains to be made in equities, as long as we fall short of anything approaching a prewar deflation in our postwar monetary regime.

Equity valuations signal deflation, yet deleveraging seems to be ending

There is now visible evidence that the Fed's monetary medicine is working. Bank credit has grown since June as commercial banks have increased their holdings of credit-market instruments. Key elements of bank lending have shown no contraction over the summer and the pace of total bank lending has declined. The commercial-paper market is growing and even asset-backed-securities (ABS) issuers have halted the decline in their commercial-paper issuance. The contraction in broad money ended in June. While calling all turning points is fraught with difficulty, this improvement in credit and money data is in marked contrast to the financial market's fears of deflation.

Corporate deposit-hoarding must end soon, with positive implications for equity prices

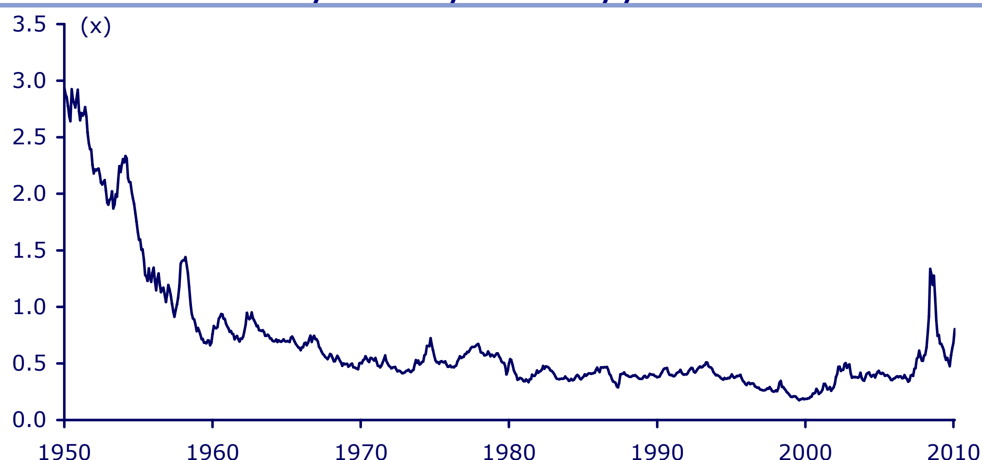
The risk of a deflationary contraction would ease materially if companies started mobilising their large war chests of deposits. Corporations cannot retain US$2.4tn in liquidity while racking up US$1.7tn in cashflow. Shareholders will demand the return of these funds as dividends unless management can fruitfully employ them. US managers have shown a wonderful ability to deploy cash in fruitless ventures (such as stock buybacks at gross overvaluations) rather than return cash to shareholders. The most likely use of these excess funds will be an M&A boom or an already evident rise in buybacks, which will be very positive for equity prices.

Major bond bear market is beginning, but equities will rise in early stages

A major rise in equity prices is very likely as investors realise that we face an inflationary future, not a deflationary one. Of course, bond prices will simultaneously decline. This is likely to be the beginning of a very long bear market in bonds, but there is much in the historical record to show that equity prices can continue to rise in the early stages of a bond bear market. This bear market should reach a stage in a few years when it has negative impacts for equity valuations and economic growth. While investors need to watch out for the extreme damage that will eventually result from that bond bear market, the current advice is clear to buy equities and sell bonds.

Div-yield ratio shows equities are cheap even when payout ratio is low

Ratio of S&P500 dividend yield to 10-year Treasury yield



Source: Robert Schiller (http://www.econ.yale.edu/~shiller/data.htm)

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Equity valuations back to 1950s levels

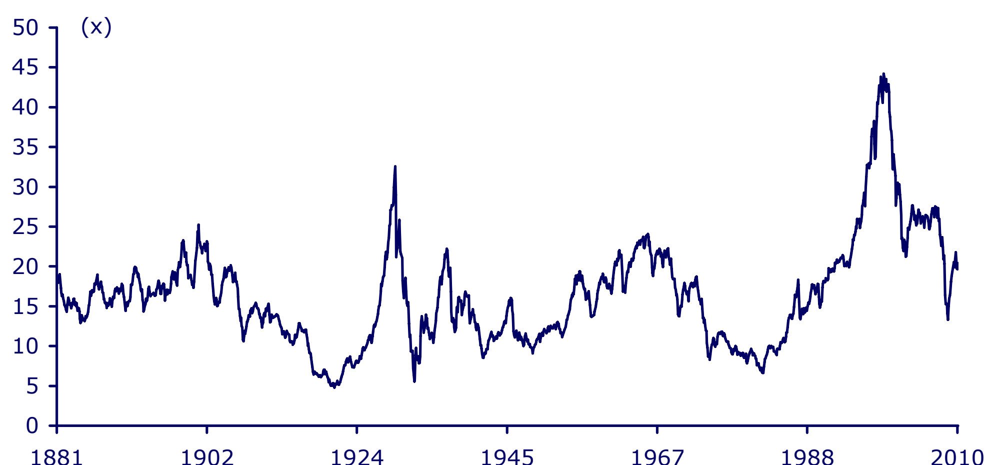
Equity valuations a more important consideration than economic growth

Today, equity valuations are much more important than the outlook for the economy. There is a significant body of evidence that there is at best only a limited relationship between economic growth and the total return from equities. While this relationship has many causes, the key, in the opinion of this analyst, rests with the issue of equity valuations. Sometimes equities simply discount so much good news that even if that good news comes to pass, returns are poor. This is why most editions of *Solid Ground* constantly refer to Shiller's cyclically adjusted PE (CAPE) as a guide to just how much good news equities are pricing in.

For the long-term investor, equities are still expensive

Figure 1

Cyclically adjusted PE (10-year average EPS)



Source: Robert Schiller (http://www.econ.yale.edu/~shiller/data.htm)

Ten years of poor returns do not make equities cheap, because in 2000 they were so expensive

Most investors are usually surprised to discover that, despite a decade of dire returns, equities are still greatly overvalued for the long-term investor. The key reason for this, as Figure 1 shows, is that they reached their largest-ever overvaluation in 2000. Over the long term, improving earnings can play a key role in reducing valuations, which need not be driven by a decline in equity prices. However real earnings for the listed sector are only just returning to their late-2000 peak, and the decline in the S&P500 Index (almost 30% from the 2000 peak) has thus just brought equities down from very expensive to merely expensive levels. The CAPE is still not far below the dangerous peaks seen in 1901 and 1966, and so long-term investors should not consider investing in equities at these levels. The dynamics of how valuations are likely to adjust downwards in the long term is discussed at the conclusion of this report. For now, let's talk about the short term.

CAPE tells us little about the equity prices over the short term

As always, the key is the definition of 'long term' in relation to signals from CAPE. Recent history suggests that CAPE becomes a better measure of future returns for holding periods of three years and longer.

While the gravity of value can assert itself at any time, there have regularly been periods when overvalued equities have become even more so. Although historically equity valuations have struggled to remain above 20x CAPE, in recent times there were two important periods when they rose very materially from such high valuations. In January 2003, the CAPE had declined to 21.2x. As Figure 1 shows, this was still very high: not far below the 24.1x reached in January 1966. From its lows in March 2003 to the highs of October

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2007, the S&P500 Index almost doubled. Of course, by early 2009 those who had decided that equities were expensive in early 2003 had been vindicated, but they first had to endure a bull market.

Those who sold equities at a high CAPE in 1995 may have been out of a job by 2000

A similar phenomenon occurred in 1995, when the CAPE again rose to the 1966 level. It continued to rise, reaching record new highs in 2000, and those who followed the CAPE missed a 150%-plus increase in the S&P500 Index. Once again, however, the long-term investor was rewarded by avoiding equities, as by 2009 the S&P500 had returned to 1995 levels. As Figure 1 shows, that five-year rise in the CAPE from already-high levels was truly exceptional.

US monetary largesse is extending overvaluation, but not forever

So while recognising the gravity of value, investors need to also be aware that CAPE cannot provide short-term guidance on future equity prices. It may be that the severing of the Fed's link to any monetary anchor is allowing a scale of monetary response that was simply impossible in the 1881-1972 period and is thus perpetuating high valuations for longer than previously possible. As long as this freedom is supported by the continued buying of US dollars by foreign central banks, it may result in the gravity of value being less immediate than it has been in the past and thus may account for the prolonged period of high valuations witnessed since 1995. As *Solid Ground* has long argued, we will live through the end of this monetary standard, as emerging-market central bankers move away from exchange-rate targeting to focus on domestic monetary conditions. That shift will severely restrict the Fed's monetary options and thus is likely to unleash the gravity of value.

In the short term, growth and inflation expectations will play a key role

Although such a shift appears inevitable, it seems it will also be gradual and thus investors need to be aware that we could once again see equities rise to much higher valuations over the next few years before a major decline occurs. Whether valuations will head higher first will be driven by whether the Fed engineers the growth and inflation which it is targeting. Given the current pricing of equities relative to bonds such an outcome is likely to push equity prices sharply higher.

The Anatomy of The Bear (published late 2005) argued that low equity valuations had been associated with deflation or the risk of deflation. Peak valuations occurred when investors believed that a new economy had developed that could provide high growth plus low inflation and interest rates. The belief in this new economy had never been higher by early 2000 and thus either inflation or deflation would shatter this comfortable illusion. While the final decline in valuations was likely to be associated with deflation, there would be inflation scares along the way driving the valuation decline as occurred from 1966-82. All of this could take a long time. The book stated that a simple average of the three long valuation declines suggested that valuations would bottom around 2014. Of course, a simple average of three events that ignores the 1929-32 collapse in valuations is likely to be of dubious accuracy. It is worth remembering that the moves from high valuations lasted from 1901 to 1920, from 1937 to 1949 and from 1966 to 1982. It is very hard for investors to try to call a bottom when it could occur anywhere between 2012 and 2019!

The real question is not how long has this process taken historically, but how long can the Fed or US government prevent the outbreak of deflationary forces that will drive the final lurch down in valuations?

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Credit data published since summer makes debt deflation even less likely

The rise in valuations from March 2009 has been driven by the realisation that government/central-bank action will prevent a debt deflation and thus prevent the eradication of equity that would have followed. Since April 2010 growth forecasts have been scaled back and for some investors a 'double-dip' threatens to be the prelude to a full-blown debt deflation. In *Solid Ground: The day the maestro died* we outlined the numerous reasons why this Japanese-style scenario is highly unlikely in the USA. Since the publication of that report in June, important positive changes have occurred that make such a debt deflation even less likely (see Section 2), but equities have continued to get cheaper, particularly relative to bonds.

Comparing bond and equity yields is dangerous for the long-term investor

Although the CAPE is the best indicator of future returns from equities, we have seen that it rewards only the long-term investor. CAPE is not widely used by most investors and there are other measures which are regularly used to prove that equities are cheap even when they can prove to be expensive for the long-term investor. Comparing yields between bonds and equities has been particularly useful for those who want to prove the 'cheapness' of equities. There are numerous problems with this approach - most notably comparing fixed-coupon investments with equity dividends, which have an element of inflation protection. The most obvious problem is that the approach assumes that the bond market is efficiently priced and thus that one can use this to assess the price of inefficiently priced equities. There is nothing in the historical record to suggest that bond markets are more efficiently priced than equities.

Bond yields have a long way to rise, so investors must be careful not to stay around too long

At this juncture we would argue that yield comparisons are particularly perilous for the long-term investor as we are at the beginning of a very major long-term bear market in bonds. However, as shown in *Solid Ground: How the rally ends* (published September 2009), equities can perform very well in the early days of a bond bear market as economic and profit growth return and valuations rise rather than fall. For investors assessing where equities will go over the next few years, the current equity/bond relationships suggest that there is considerable upside for equities if the USA can simply avoid a debt deflation. Figures 2-5 show just how cheap equities are relative to bonds.

All four charts show that a dramatic shift in equity valuations occurred after WWII. In the prewar period, dividend yields exceeded the 10-year Treasury yield and this lasted until the beginning of the so-called 'reverse yield gap' in 1958. There are various theories as to why this relationship may have changed, but the most likely explanation is that postwar monetary arrangements were inherently more inflationary than the gold standard. With the loosening of the monetary anchor, the Federal Reserve had more freedom to pursue reflation in difficult times and thus prevent the deflationary adjustments so common in the gold-standard era. In the postwar system, corporate cashflow was much less prone to collapse and equity much less likely to go to zero even for highly geared companies. Recent events have brought into question whether even our unfettered central bankers can avoid deflation, and hence some of these yield-comparison metrics are flirting with levels not seen since the birth of Bretton Woods. We deal with the evidence for reflationary success later in this report, but at this stage we want to focus on the valuation data covering the period from 1871 to the present and, in particular, the post-WWII era.

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Dividend-yield gap is narrow even though payout ratio is low

Figure 2

Dividend-yield gap from 1871 . . .

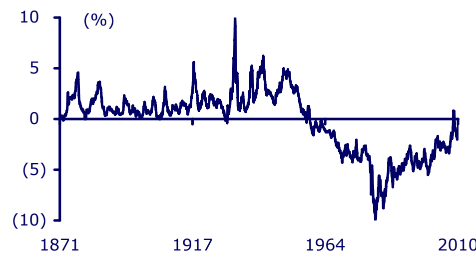
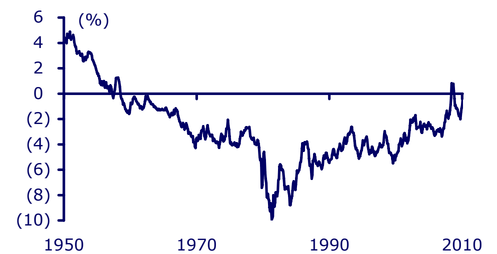


Figure 3

. . . and from 1950



Source: Robert Schiller (http://www.econ.yale.edu/~shiller/data.htm)

Figures 2 and 3 show how the US equity yield is now just 49bps below the yield on 10-year Treasuries. This is an extremely low differential. It existed from December 2008 to May 2009, and investors who bought equities then were richly rewarded. Prior to this one has to go back to 1962 to find a similarly small differential. Equities suffered a major setback early in 1962 as John Kennedy waged war on the US steel companies. This was early in the life of the reverse yield gap, but those who plunged into equities at the 49bp differential in June 1962 made a 26% gain over the next 12 months. So basically since the birth of the reverse yield gap, equity investors have only racked up very material gains from equities when the gap is this low.

Dividend-yield ratio is back to 1963 levels

Figure 4

Dividend-yield ratio from 1871 . . .

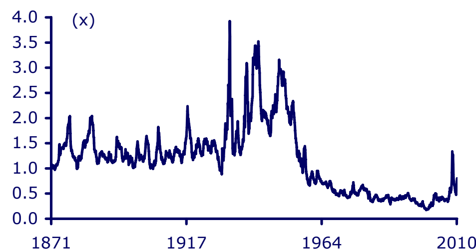
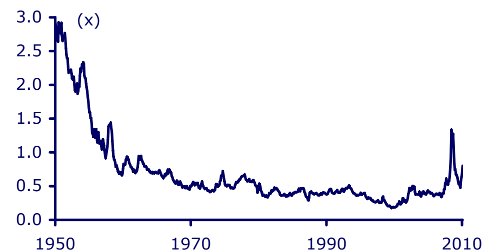


Figure 5

. . . and from 1950



Source: Robert Schiller (http://www.econ.yale.edu/~shiller/data.htm)

Every time the yield ratio reached this level post 1958, strong rises in equities followed

The dividend-yield ratio tells a very similar story to the dividend-yield gap. Today the dividend yield on equities is 80% of the yield on 10-year Treasuries. This was recently surpassed from November 2008 to May 2009 and investors who bought equities then have been richly rewarded. Prior to this one would have to go back to March 1963 to find a period when the dividend yield was so high relative to the 10-year Treasury yield. The high relative yield of equities in 1963 was during a period when the reverse yield gap had just developed and the ratio was making its first ever decline below 1.0x. It reflects the drop in the yield of equities to below that of bonds. This was an excellent time to buy equities, as the postwar bull market raged on until the end of the 1960s.

Low payout ratios and stock buybacks make dividends a poorer indicator than earnings

Figures 2-5 suggest that equities represent remarkable value relative to bonds. However they may underestimate just how cheap equities have become. This is because dividend growth has been subdued despite recent rapid earnings growth and also because US corporations are increasingly returning cash to shareholders via share buybacks. Figure 6 looks at the US dividend payout ratio back to 1965.

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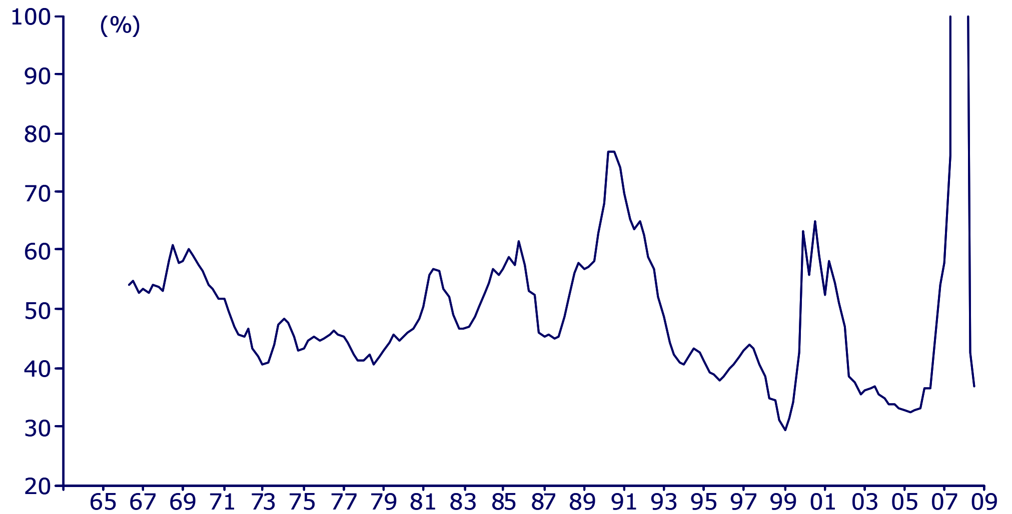
Low payout ratio and high dividend yield ratio is unique in the modern era

Figure 6

S&P500 dividend as a % of S&P500 EPS



Source: Datastream

With the payout ratio so low, the downside for dividends is very limited

This chart's vertical axis is limited to 100%, as otherwise the rise of the dividend payout ratio to 300% in the recent crisis would make the long-term trend difficult to discern. It shows how the dividend payout ratio is back to the very low end of its range. This provides scope for it to grow more quickly than earnings in the year ahead and provides considerable protection should earnings decline.

The chart also shows how dividend payout ratios have declined steadily since the early 1990s. This decline coincides with the rise of the stock buyback as a method for management to return cash to shareholders. Given this structural shift, a better way to gauge the value of equities relative to bonds is by using the earnings yield.

Now similar to 1974 and 1979, when 30%+ rises in the S&P followed

Figure 7

Earnings-yield gap from 1871 . . .

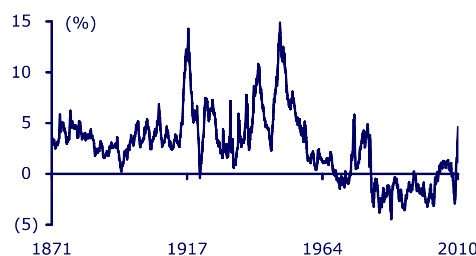
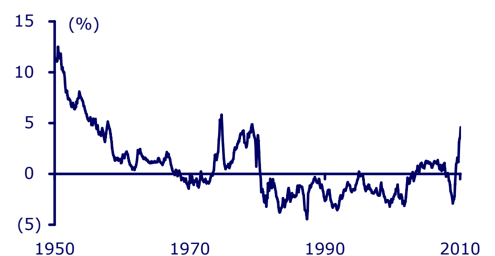


Figure 8

. . . and from 1950



Source: Robert Schiller (http://www.econ.yale.edu/~shiller/data.htm)

Earnings decline in 2009 masked just how cheap equities had become

The earnings yield looks at corporate earnings as a percentage of the stock price. It is the inverse of PE, and if every company had a payout ratio of 100% it would be a guide as to how much could be returned to investors in dividends in any given year. Currently the earnings yield on US equities is 459bps higher than the yield on 10-year Treasuries, a gap that has not been seen since 1979 and which did not occur in 1Q09 due to the collapse in earnings at that time. Investors who bought as the yield gap hit this level in June 1979 then saw equity prices rise by 33% by April 1981. Prior to that the

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yield gap last reached its current level in July 1974, and investors who bought then made a 47% profit by February 1976.

The only other occasion when the earnings-yield gap reached current levels was in November 1957, when the fundamental shift in the relationship between equities and bonds was just beginning.

Earnings-yield ratio at levels not seen since birth of the reverse yield gap

Figure 9

Earnings-yield ratio from 1871 . . .

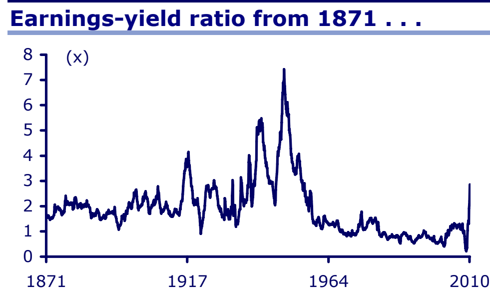
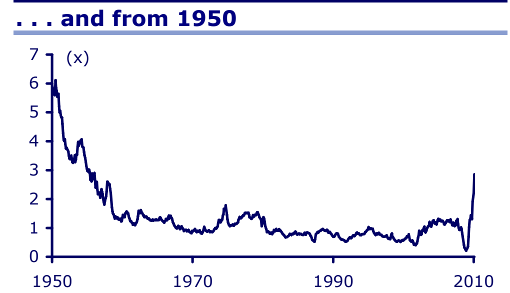


Figure 10

. . . and from 1950



Source: Robert Schiller (http://www.econ.yale.edu/~shiller/data.htm)

Earnings-yield ratio back to 1956 levels

The earnings-yield ratio has now reached 2.86 - ie, the earnings yield is 186% higher than the 10-year Treasury yield. Once again this is remarkably high. Equities have just not been this cheap relative to bonds since 1956.

Based on the valuation metrics above, the short-term holder of equities has never lost money when buying at these valuations relative to bonds. Indeed, valuations are so extreme that returns in excess of 20% would normally follow over the following year.

Equities are currently pricing in very large earnings declines

All equity valuations can be justified as they depend upon an uncertain future. Thus even what are apparently exceptionally cheap valuations for equities we see in the analysis above can be justified, particularly if our future is a deflationary depression. This analyst does not fear such a scenario, but obviously there are many who do. For such investors, we can use the yield analysis to calculate the decline in dividends and earnings that would be necessary for these ratios to decline to average levels. In calculating the average we will get very different numbers depending upon whether we use the data from 1871-2010 or from the postwar-to-2010 period. Given that we have lived in a world of largely unfettered monetary policy since WWII, the following analysis is based on the average yield ratios that have applied since the emergence of the reverse yield gap in 1958.

Can earnings really fall 60%+ as suggested by earnings-yield analysis?

Figure 11

Implied earnings and dividend declines assuming current yield on US Treasuries

	1958-2010 average	Implied decline (%)
Dividend-yield gap (%)	(3.60)	100
Dividend-yield ratio (x)	0.49	40
Earnings-yield gap (%)	(0.20)	68
Earnings-yield ratio (x)	1.00	65

Source: Robert Schiller (http://www.econ.yale.edu/~shiller/data.htm)

Since 1958 equities have on average produced a dividend yield 360bps below that of 10-year Treasuries. The current 10-year Treasury yield is 2.47%, so it is mathematically impossible for dividend yields to be 360bps below this! Even if dividends were eradicated, the yield gap would still be less than the 1958-2010 average.

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Dividends down 21% but equity valuations imply another 40% decline

As a measure of relative returns, the dividend-yield ratio is perhaps a better indicator of expected dividends. The ratio implies that dividends would have to fall 40% to reduce equities to their average valuation over the 1958-2010 period. It has to be remembered that dividends are already 21% below their September 2008 highs and that the dividend payout ratio is near its all-time low. A 40% decline from this level would take nominal dividends back to their September 1995 level. Those who expect a bleak future would presumably have no problem agreeing that the 10-year Treasury yield is unlikely to rise in the foreseen 'double dip.' If that is the case then the dividend-yield gap and yield ratio analysis suggests that equities are already expecting a 40%-plus decline in dividends in this double dip. That would be twice the percentage decline we have just witnessed in the Great Recession and a total decline of 53% from the 2008 high.

Market expects earnings to stabilise at levels first seen in 1994

The earnings yield would have to decline by 479bps before the earnings-yield gap returned to its 1958-2010 average. Such a decline would be achieved by a 68% decline in earnings. The earnings-yield ratio would have to decline from the current 2.86x to 1.0x for equities to trade at the 1958-2010 average. Again, this would require earnings to decline by 65%. A decline of this magnitude would take earnings back to levels seen in early 2009 and 2001 and first reached in 1994.

Equities pricing in much more than a double dip

If you are an investor who expects a double dip, you probably foresee a stable or declining bond yield. Thus at current levels equities are already pricing in a huge decline in earnings and dividends. If you don't believe in a double dip of that magnitude, it is difficult to be negative on equities.

Earnings-yield buy signals in 1974, 1979 were not for long-term investors

As already mentioned, there is much more than yield analysis for the long-term investor. This analyst is strongly of the view that major gains are to be had in US equities, but despite extreme yield ratios this is not the beginning of a new long-term bull market in equities. Such pessimism is grounded in a belief in a great bear market in bonds. In this regard the earnings-gap and earnings-yield charts from the 1970s are of great interest. These ratios were very useful in indicating when investors could make great one-year returns by investing in 1974 and 1979. However they did not signal that the long bear market was over.

Equities can continue to rise in early-stage bond bear markets

Although the S&P did not return to the 1974 lows in 1982 in nominal terms, it was 30% lower in real terms. Similarly while purchasers in June 1979 made strong positive gains over the next 18 months, they lost 20% in real terms by June 1982. If the mean reversion of the CAPE is to continue, equity valuations have a long way to decline before we reach the great buy-and-hold opportunity that tends to accrue to every generation. With the CAPE above 20x and likely to decline to below 10x, a great bear market in bonds seems a much more likely catalyst for that decline, given the current yield-ratio analysis. In due course that bear market in bonds would not only have negative impacts on equity valuations but would produce a risk-free rate that would grind down economic activity and profits. In last year's report (*Solid Ground: How the rally ends*) an analysis of postwar periods when bond yields rose from low levels suggested that the negative impacts for equities would not be expected to accrue until bond yields approached 5.5%.

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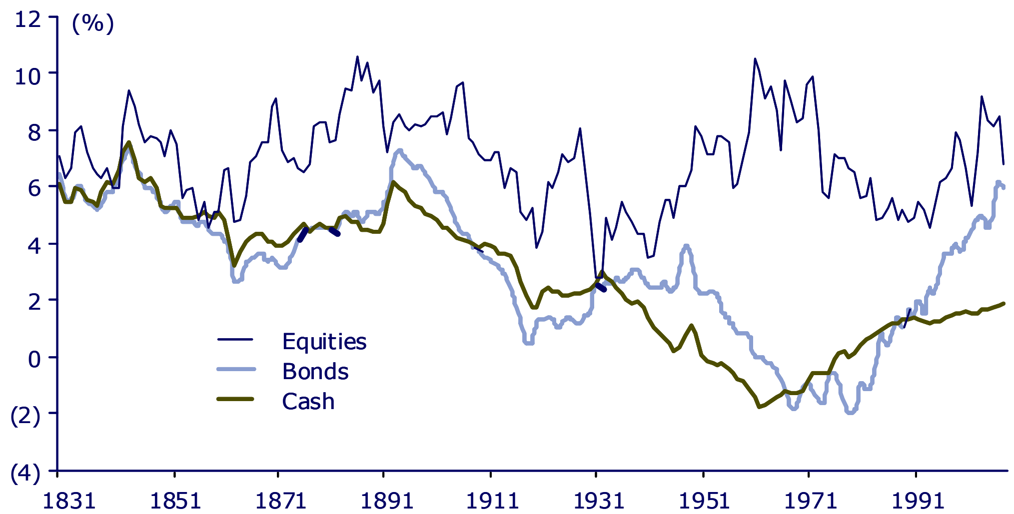
US Treasury returns are very near 180-year highs

Those investors of a long-term disposition should study Figure 12, which shows rolling 30-year real returns for cash, bonds and equities in the USA. I am indebted to Andrew Smithers and Smithers & Co for allowing me to reproduce this chart of such long-term returns.

Figure 12

US rolling 30-year real returns



Source: Smithers & Co

The chart shows the exceptionally high returns from bonds over the past 30 years and how these returns have almost equalled the real returns from equities over the same period. This has happened only two times since the middle of the 19th Century. On both occasions when bond returns have neared equity returns, a major bear market in bonds has followed. Given that the data above is for rolling 30-year periods it tells investors little about the relative returns for investors over the short term, but for the long-term investor it offers a warning that if annual bond returns continue to exceed equity returns then we are entering very new territory indeed.

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US private-sector deleveraging ends

A belief in deleveraging in the USA is hardwired into investors

If you say something long enough you can come to believe it. For investors, the word 'deleveraging' now seems to be hardwired into their belief system - so much so that week after week, the data showing that deleveraging is probably over is cheerfully ignored. The comprehensive and timely data for US banks shows bank credit expanding, as does the timely but partial data for non-bank credit. While all the focus is on the banks, investors need to remember to also look at non-bank credit, which accounts for 78% of total private credit in the system. Trends in the non-bank system are more difficult to assess, but are crucial, particularly in assessing any change in the demand for credit.

Bank credit and commercial paper are both growing

Headline bank credit data for the whole of 2010 is very misleading, as a portfolio of about US$260bn in credit-card receivables came back onto balance sheets at the end of March. However the post-March data does provide an accurate picture. Over the summer, US bank credit expanded as banks loaded up on credit-market instruments, and loans in key segments showed signs of no contraction. Outside the banking system, the commercial-paper (CP) market is growing for the first time since 2007. Perhaps most importantly, the shrinkage of the so-called 'shadow banking system', which has accounted for the bulk of private-sector deleveraging, may have slowed markedly since June. The following data indicates that the US private sector's deleveraging is ending.

Bank credit has expanded

From its low on 16 June, bank credit has expanded by US$103bn (6% annualised). This includes loans and holdings of credit-market instruments. The increase in bank credit since June is entirely accounted for by increased holdings of credit-market instruments.

Total bank loans continue to contract

Total bank loans (accounting for 74% of total bank credit) continues a mild contraction at an annualised pace of 1.6% since 16 June when there was a notable change in the pace of loan contraction.

Key segments of bank lending have stopped contracting

Bank loans are divided into four major types, shown in Figure 13.

Key sectors of bank lending have stopped contracting

Figure 13

US commercial bank loans by category

(US$bn)	End May	End June	End July	September
Commercial & industrial	1,244	1,235	1,242	1,240
Real estate	3,687	3,674	3,642	3,642
Construction	1,161	1,170	1,166	1,155
Other	781	788	776	795

Source: Federal Reserve

Annualised rate of bank-loan contraction is just 1.6%

The table shows that commercial and industrial loans stabilised over the summer, backing up the Fed's Senior Loan Officer Survey. The slide in consumer lending continues and since the end of May has been contracting at an annualised pace of 2.7%. Real-estate lending has declined since the end of May at an annualised rate of 4.9%, but did not contract in August, while the 'other loans and leases' category grew at an annualised rate of 7.2% over the summer. As the Senior Loan Officer Survey notes, banks find themselves very uncompetitive relative to the public credit markets. The survey points to some easing of bank credit conditions, but given this discrepancy in pricing it is unlikely that bank credit will lead the total credit cycle.

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Bank loan growth will probably lag total credit growth

Even though all these numbers for outstanding bank loans will be negatively impacted by loan charge-offs, bank credit is growing, total bank lending is contracting at less than 2% per annum and key loan segments have stopped contracting. Is this the deleveraging that is making the front page of the newspapers? As we will see, the data is considerably better if we look at what is happening to credit creation outside the banking system.

Commercial-paper market is growing

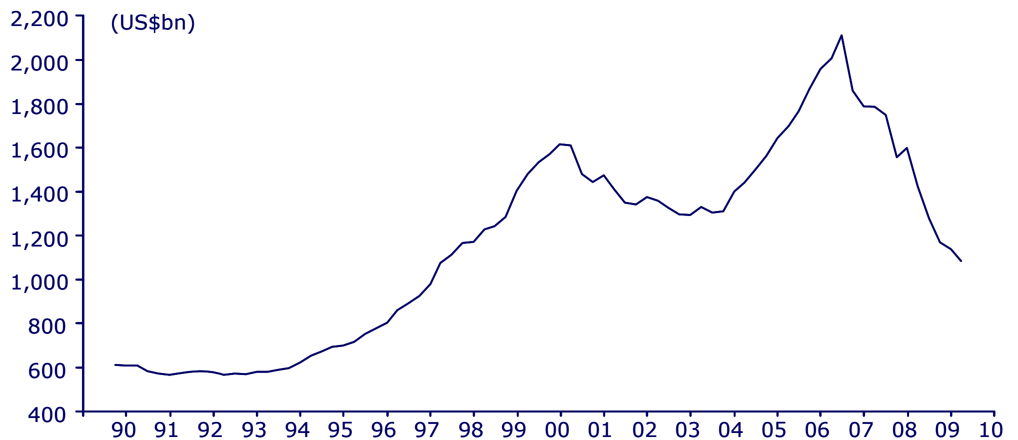
CP financing is growing following a steep decline

While commercial paper is only one segment of non-bank private credit, it is the section of that marketplace for which we get timely weekly data. Such a partial picture clearly has its problems, but changes in this market can provide guidance on credit demand in the sector overall. As Figure 14 shows, one of the key drivers of the private-sector deleveraging of the USA was the shrinkage in the CP market.

Collapse of commercial-paper financing a key element of deleveraging

Figure 14

Commercial paper outstanding



Source: Datastream

ABS pools the key issuers of commercial paper prior to the Great Recession

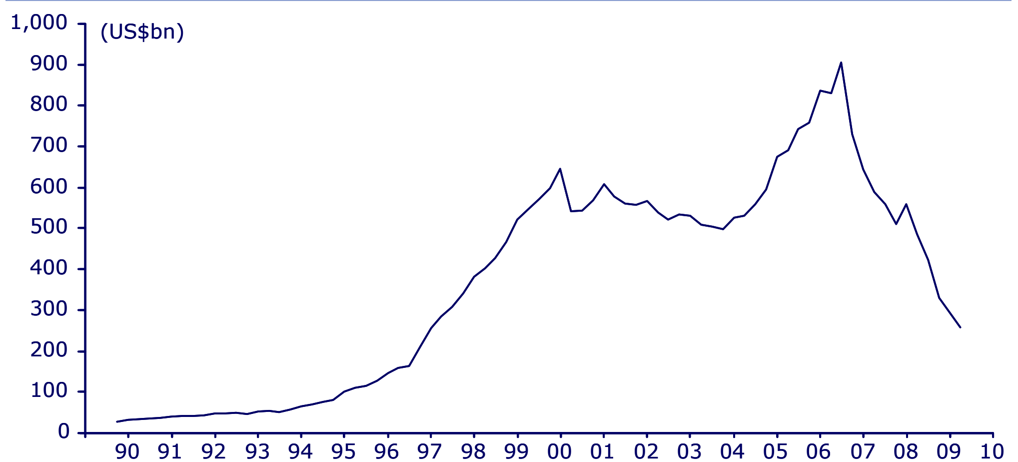
This contraction is not surprising as the 2004-07 run-up in commercial paper was associated with financing for the shadow banking system.

Figure 15 shows how dramatically the outstanding commercial paper issued by the ABS sector has declined.

CP financing by ABS system fell back to 1998 level

Figure 15

Total commercial paper issued by ABS



Source: Datastream

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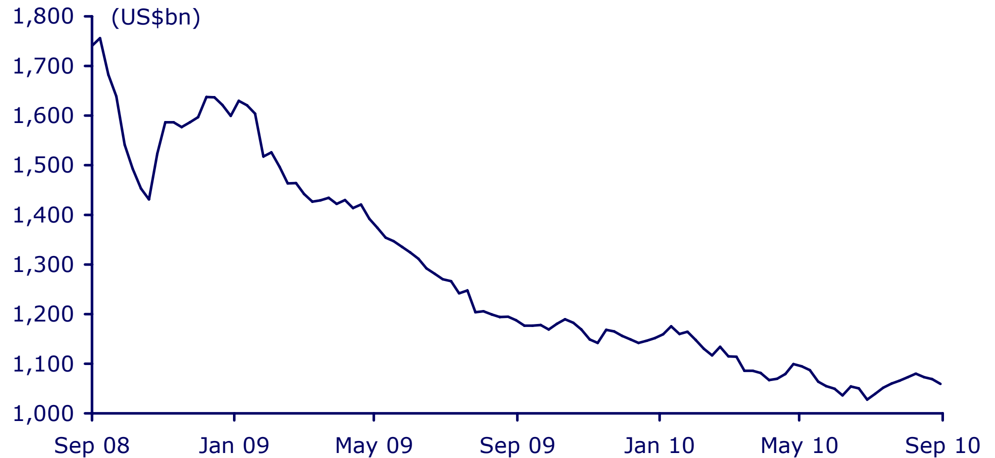
Figures 12 and 13 run to the end of 1Q10. From there, total commercial paper outstanding declined from US$1,080bn to US$1,028bn by 30 June. Since the end of June, the market has stabilised. Figure 16 shows total commercial paper outstanding up to 1 September 2010.

Over the summer, the contraction ended

Figure 16

Total commercial paper outstanding



Source: Federal Reserve

Early signs of growth in the CP market

Total commercial paper outstanding bottomed on 30 June and has since risen by US$31bn. While this represents a 17% annualised growth rate, the data is clearly very short run and there was a noticeable setback in the second half of August. This may or may not point to a releveraging of the USA, but it is very clearly at odds with a financial marketplace that has accepted that deleveraging is a given.

If a US$1,154bn decline in CP financing is over, can we still deflate?

Commercial paper declined by US$1,154bn from its peak in May 2007 and accounted for the bulk of private-sector deleveraging. Surely the evidence that this 53% decline in a key element of private sector credit outstanding is over is an important sign that further deleveraging does not lie in our future? With commercial paper outstanding back to its 1Q98 level, isn't it possible that the contraction of the shadow banking system has ended - or is at least dramatically slowing? And if the US economy and financial markets have survived such gross deleveraging, is it really the time to call for a debt deflation if that deleveraging is ending?

Financial system has stopped shrinking its CP issuance

All three key segments of CP financing have stopped declining

The time to worry about deleveraging and debt deflation is behind us. Figure 17, which shows trends among the three classes of commercial-paper issuers including ABS issuers, also suggests grounds for confidence.

Nonfinancial issuers have been increasing their CP financing since January

Commercial paper issuance is divided into nonfinancial issuers, financial issuer and ABS issuers. Nonfinancial issuers are just a small part of the CP market (13% of the total) but their commercial paper outstanding has been rising rapidly. Nonfinancials had US$213bn in commercial paper outstanding by mid-November 2008 and this shrank to a low of just US$95bn by the end of December 2009. As at 25 August 2010, total outstanding commercial paper had risen to US$136bn, representing an annualised rate of growth of

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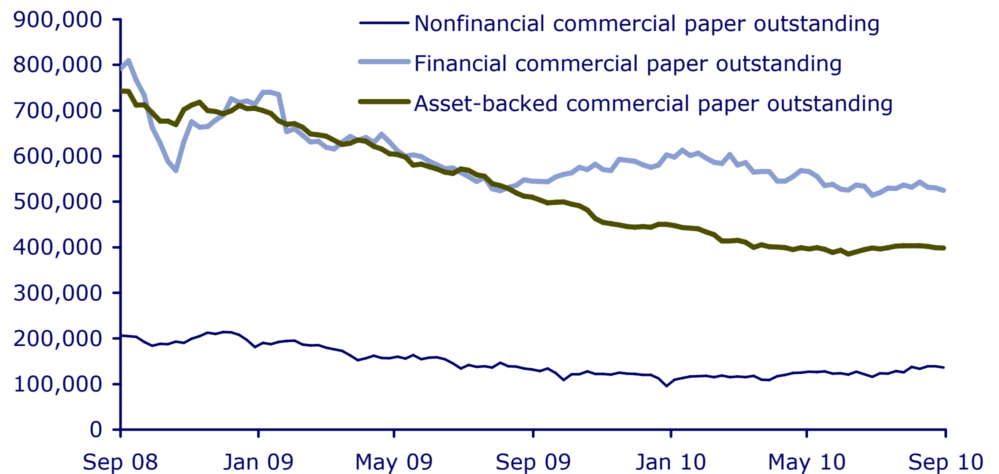
64%. While this sector has been the key driver in stabilising the total amount of commercial paper outstanding, there have been more recent positive trends among the financial issuers.

Nonfinancial companies are growing CP financing at annualised rate of 64%

Figure 17

Breakdown of commercial paper outstanding



Source: Federal Reserve

Crucially, the ABS system saw its CP issuance bottom in June

As we have seen above, the key element driving a contraction in commercial paper outstanding has been the shrinkage of the ABS sector. ABS commercial paper peaked at US$1,201bn in August 2007 and declined to US$385bn on 9 June 2010. Since that US$816bn deleveraging, the sector has increased its commercial paper outstanding by US$14bn to US$399bn by 1 September. Such short-run data can clearly be dangerous, but this represents an annualised rate of growth of 15%. This rebound may prove to be temporary, but if it does not then there is clear evidence that the shadow banking system has at least stopped deleveraging. An end of deleveraging in this portion of the private credit system would be a particularly positive step towards credit growth.

Financial companies are also now growing their CP financing

The remainder of the commercial paper issuance (non-ABS financial issuers) had peak issuance of US$886bn in late May 2008. There was then a decline of US$372bn to a low point of US$514bn by the end of June 2010. Since then the sector's commercial paper outstanding has increased by US$10bn to US$524bn by early September. Once again these are early days, but that rebound represents a 10% annualised rate of growth in commercial paper outstanding. Many doubt whether there is any demand for credit, but these early signs from the commercial paper suggest that these crucial sectors of the economy are interested in increasing their gearing.

There is no timely data for bond financing by the financial system and thus things are not clear

So there is evidence that de-leveraging is ended but we cannot be certain of this as we have only partial visibility of the non-bank credit system. As already noted, commercial paper is only one part of private-sector non-bank credit and is only one-tenth the size of the corporate bond market. So it is of course possible that the expansion of commercial paper is being more than offset by contractions in corporate bonds and thus the evidence for private-sector credit demand from the commercial paper market is misleading. Timely and comprehensive data for the entire US corporate bond market is not available, although we do have data for the amount outstanding from

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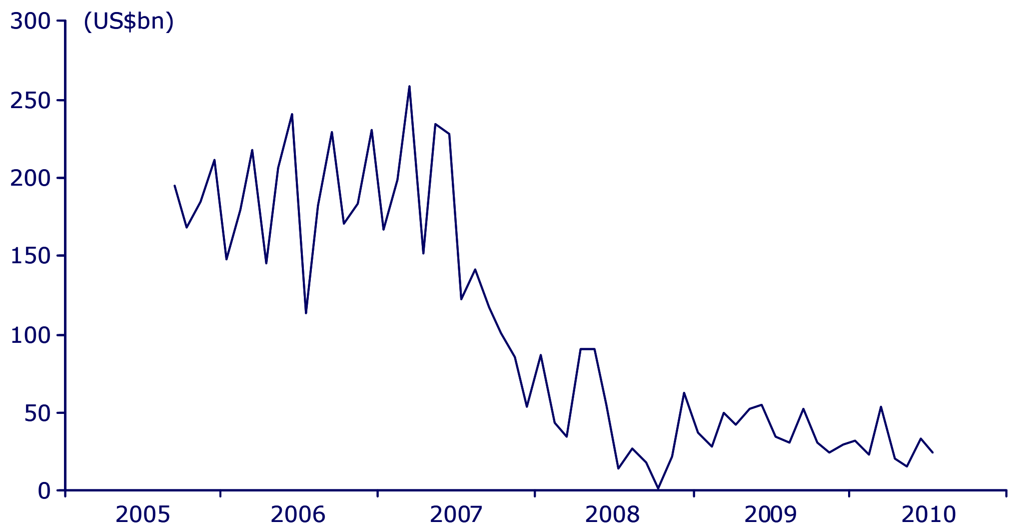
nonfinancial issuers to the end of August, which shows a continued expansion. However, as Figure 18 shows, it is the financial issuers that have been contracting their bond credit and it is their behaviour that is key to overall private-sector credit demand.

The main culprit for the decline

Figure 18

Gross proceeds of new US financial corporate-bond issues



Source: Datastream

If financial firms have stopped shrinking their CP financing, will they stop deleveraging?

The chart shows that the financial sector is entirely responsible for the contraction in corporate bonds outstanding issued by US corporations. Nonfinancial corporations grew their total corporate-bond issuance steadily throughout the recession. Indeed, if we add corporate bonds and commercial paper together, nonfinancial issuers have grown their non-bank credit in every quarter through the Great Recession. We have clear evidence that this sector has been rapidly increasing its commercial paper outstanding since the end of 1Q10 and there is also evidence that corporate bonds outstanding have risen by around US$100bn from March to the end of August. Thus all the data shows an increase in non-bank credit in the private sector, with the major caveat that we do not have data for financial-sector corporate bonds outstanding from the end of March to the present. It is still possible that declines in that sector have more than offset the expansion visible elsewhere in the total credit system.

Bond financing has not contracted as rapidly as CP financing so it might stabilise more quickly

The US$126bn decline in corporate bonds outstanding from the 2Q08 peak comprises a US$556bn increase in credit issued by the nonfinancial sector and a US$682bn decline by financial issuers. With the stability in the total commercial-paper market and the continued growth in nonfinancial issuers' corporate bond credit, it would take a decline in excess of US$97bn per quarter in the financial sector's corporate-bond issuance to result in a net deleveraging. If the 3.1% contraction in financial-sector bond financing in 1Q has abated to a 1.7% contraction since the end of March, then the decline in non-bank credit in the USA has ended. The decline in 1Q was US$179bn and should it be anything less than a contraction of US$97bn per quarter then deleveraging is probably over.

So given the lack of data since then, what secondary evidence is there to assess whether that first quarter rate of shrinkage in corporate bond financing by financials has continued?

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Bond financing for nonfinancial companies is still growing

The recent end of the finance sector's decline in CP finance suggests that the rate of decline in bond finance is also declining. In 1Q10, the financial sector contracted its commercial paper outstanding by 8.2% over the previous quarter. As we have seen, the contraction ended in June. Does this signal that the much smaller QoQ contraction of 3.1% in corporate bonds outstanding in 1Q has also ended?

The Securities Industry and Financial Markets Association (Sifma) compiles more timely data for trends in the non-bank credit system. That data certainly suggests that the financial sector will have reduced its corporate bond credit in the second quarter.

A decline in agency MBS issuance suggests financing is still declining

Issues of US corporate bonds, which are an indication of the size of the total market, fell to US$52bn per month in 1Q10, compared to US$94bn in 1Q09 and US$71bn in 4Q09. While the runoff in existing corporate bonds will impact totals bond credit, these numbers suggest that it is difficult to see how this element of non-bank credit could have grown in 2Q10. While issuance picked up to US$72bn in July this is still a level of issuance that has resulted in a contraction in the size of the corporate bond market in recent years. Thus, despite the stability in ABS commercial-paper credit, this suggests that the contraction in financial-sector bond credit continued in 2Q.

Sifma also compiles up-to-date data for the size of the ABS market. As these are the assets that commercial-paper and corporate-bond issues are financing, trends in this market can provide some guidance as to credit outstanding within the system. The Sifma data shows a quarterly contraction in ABS, as shown in Figure 19.

Since the Lehman bankruptcy, agency MBS issuance has swamped private issuance

Figure 19

Quarterly decline in total non-agency ABS outstanding

(US$bn)	2009				2010	
	1Q	2Q	3Q	4Q	1Q	2Q
Total	74	64	49	55	66	79

Source: Sifma

There is a public issuer of MBS to take over the role

There was no slowdown in the contraction in the non-agency ABS system in 2Q10. This corresponds with commercial-paper issuance by the ABS sector, which did not bottom until the end of that quarter. While there are signs of stability in the size of ABS outstanding for auto loans, student loans and even commercial mortgages, the decline in the home-mortgage market continues. This is all but inevitable as private-sector ABS issuance basically stopped in 2008 (with Freddie and Fannie taking almost all of the new business) and thus privately created mortgage-backed securities (MBS) are shrinking due to maturity, default and repayment. This shrinkage in privately issued ABS has been partially offset by a growth in the agency MBS market.

The smaller the private MBS sector, the less negative its shrinkage

The non-agency MBS market, which represents 56% of the total privately issued ABS business, has now shrunk by 32% (US$1,021bn) from its 3Q07 peak. Non-agency MBS outstanding is now back to its early 2005 levels. A contraction here seems likely to continue, but its negative impact is declining as it shrinks in size and as other elements of credit grow. While we cannot know for sure whether the shrinkage of the shadow banking system is really over, the scale of its decline so far suggests future shrinkage must be at materially smaller dollar amounts. With other elements of credit growing, any continued deleveraging will thus have a much smaller net impact on total credit. If the USA avoided a debt deflation during that rapid deleveraging, why is it likely to happen now?

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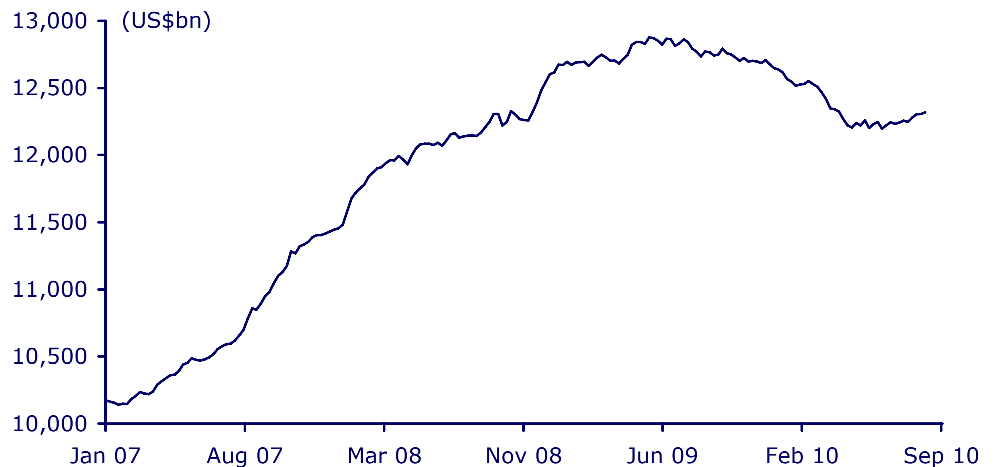
Key elements of credit are growing and so is broad money

The above analysis attempts to look through the fog of a complicated US system to conclude that we have reached a turning point in the credit cycle. Recent data also suggests that there is a change in trend in the monetary situation. The Federal Reserve no longer publishes data for the broad measure of money, M3. However the CLSA team at *Greed & fear* (G&F) does attempt to reconstitute something close to the old M3. The G&F data uses M2 and adds large time deposits at banks and institutional money funds. This is not quite M3, but when M3 was last published the G&F measure was just 9% short of the official number. If we accept that this is a good proxy for M3, then broad money in the US is growing. Figure 20 shows how US M3 peaked in June 2009 and then declined 5.3% to reach a low on 14 June 2010. Bottoming at the same time as bank credit, it was showing steady growth, based on the last available data as at 23 August. Over the 10 weeks since it bottomed, M3 has posted an annualised growth rate of 5.2%.

The USA did not deflate when M3 declined, so why would it do so now?

Figure 20

***Greed & fear* proxy For M3**



Source: CLSA Asia-Pacific Markets, Federal Reserve

If broad money has stabilised, why does everyone expect deflation?

This is a short-term change in trend and as with the bank credit data, caution is necessary. However a good reconstruction of broad money in the US shows that the decline in M3 also ended in June 2010. This all happened at a time when the movement in bonds and equities suggested that we were on the verge of a steep deflation. If that deflation did not develop during the June 2009-June 2010 decline in M3, why is it likely now?

Growth in key credit sectors may outweigh continued MBS contraction

As we have seen, key segments of bank loans have stopped contracting, and bank credit, the commercial-paper market and corporate-bond financing by non-financials are also growing. These positive changes suggest that deleveraging in the USA is ending. Unfortunately, we do not have timely data for trends in the large and important corporate bond market for financial issuers. While this is likely to still be contracting, this is less important as that business shrinks in size and also as the contraction of the non-agency ABS is partially a reflection of credit expansion in the agency MBS. The third quarter may go down in history as the period when the deleveraging of America ended.

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The end of deposit hoarding

While credit growth will bring the US economy back into life, an end of deposit hoarding will also play an important role

The good news for the US economy is that people and institutions are not hoarding cash: the bad news is that they are hoarding deposits. It was a hoarding of cash that destroyed the liability side of banks' balance sheets and enforced a massive contraction of bank credit in the early 1930s. Today, due to deposit insurance and additional government actions, we have stopped short of the rush to cash, but the hoarding of deposits still continues. While this is a much less dangerous dynamic than cash hoarding, it is clearly negative for economic activity and asset prices. An end to hoarding would spur economic activity and inflation and improve the outlook for asset prices. Crucially, such a shift with such an impact should trigger the desire to borrow and lead to an expansion of credit and money. Fortunately, an end to deposit hoarding is highly likely, as a material portion of this liquidity is accumulating in an institution incapable of constantly accumulating deposits: the corporation.

Idle cash in companies is a temporary phenomenon

Although corporations are a key driver of the deposit hoarding now underway, they are institutionally ill-suited to this role. The corporate form, at least as it has evolved in the USA, is constructed to maximise return on invested capital and by doing so to maximise returns to shareholders. Shareholders can only access the earning abilities of unique corporate assets by buying shares in the company. Cash is a generic asset with reasonably generic returns and shareholders can get these returns with cash outside the corporate form. Listed companies thus cannot continue to hoard deposits, as the demand for the return of such deposits to shareholders is inevitable. While an individual could chose to spend their entire life building up a cash hoard, a listed company is unlikely to get away with accumulation in this form for more than a few quarters. Thus, cash hoarding by corporations can only be a temporary phenomenon.

Company liquid balances soared during the recession

So just how big has corporate America's hoard of deposits become? The Flow of Funds statistics probably provide the most detailed - if least timely - insight into the situation. Figure 21 shows listed and unlisted US nonfinancial corporations' domestic deposits and money market mutual-fund (MMMF) holdings.

Liquid balances in nonfinancial firms have reached US$2.4tn

Figure 21

Nonfinancial corporations' holdings of deposits and MMMF

(US$bn)	2005	2006	2007	2008	2009	1Q10
Total	1,837	1,934	2,083	2,152	2,376	2,369

Source: Federal Reserve

Annual corporate cashflow has risen 30% during the recession

The Flow of Fund statistics usefully divide deposits into local and foreign. These figures show minimal foreign deposits, thus allaying one fear that the large deposit balances accumulating on US balance sheets are being held offshore. We need also to consider that these deposit balances are accumulating during a period of record-high corporate cashflow. The National Income Product Accounts (NIPA) figures for 1Q10 suggest that nonfinancial corporations will have cashflow in excess of US$1.7tn this year, and cashflow will be US$400bn (30%) higher this year than it was before the recession began in 2007.

The nonfinancial corporate sector's percentage holding of US checkable deposits is at very high levels.

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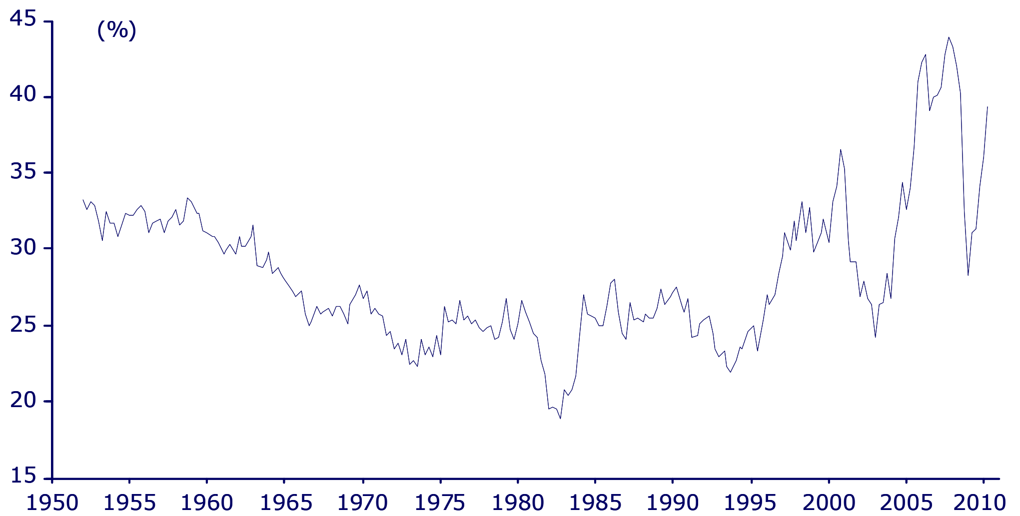
Companies hold almost 40% of all US checkable deposits

Figure 22

Percentage of US checkable deposits held by nonfinancial corporate sector



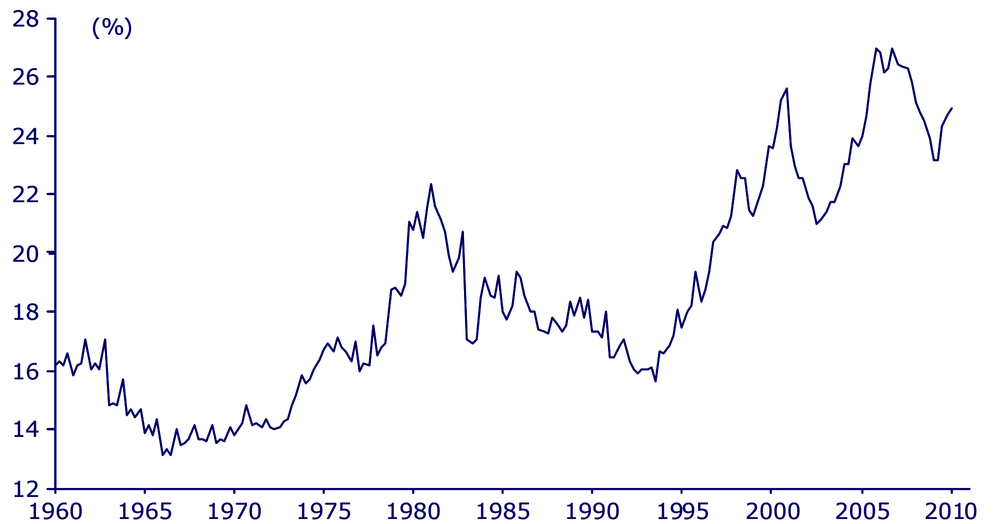
Source: Datastream

If we broaden the definition of liquidity to include time deposits and MMMF, we see that the nonfinancial corporate sector controls an ever-larger proportion of US liquidity.

Company ownership of broad liquidity is near record highs

Figure 23

Corporate checkable deposits, time deposits and MMMF as a % of MZM



Source: Datastream

Individuals can hoard deposits; companies cannot

The corporate sector now holds around one-quarter of money zero maturity (MZM), the broadest definition of money officially available. As already stressed, the corporation is not an institution formed to accumulate deposits. Indeed much of the post-1995 period has been characterised by corporations trying to deploy such balances, through stock buybacks or M&A. As long as this accumulation of liquidity continues, a similar dynamic is likely and we should not expect these deposits to be hoarded as they might be if held by an individual.

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Corporate wealth accumulation is unsustainable, long-term

While accumulation in this sector strongly suggests that the mobilisation of liquidity cannot be far off, it does raise much bigger questions about the future role of the corporation. The corporation's ability to prosper in difficult economic times, to maintain profits and to boost its share of national wealth in times of high unemployment is something that will eventually come under societal scrutiny. The accumulation of such wealth in institutions with a short-term focus and a need to do something will increasingly be seen as unacceptable. Of course, any company that realises the inevitability of such scrutiny and the potential tax implications may wish to spend its liquid balances today rather than hold them out as bait for a government in straitened circumstances. In the long term this accumulation of liquidity may pose margin problems for the corporation, but for the next few years the real problem is how to spend it.

Only negative use for this corporate wealth is the repayment of bank loans

It is the contention of this report that accumulated corporate liquidity will soon have to be deployed, with positive impacts for economic growth, inflation and an equity market increasingly expecting contraction and deflation. There is probably only one use of hoarded corporate deposits that could be negative for financial markets: if companies decided to use excess deposits to repay bank credit. This would have a negative impact on credit and, all other things being equal, money. If such action produced a decline in broad-money growth then we would once again be facing the debt deflation that characterised the 1930s.

Other foreseeable uses of such cash are positive for growth or equity prices

The good news is that the evidence is that corporate degearing has ended. If such repayment of debt does not occur, then there is a high probability that the institutional dynamic will force an end to the corporate hoarding of deposits, with important positive implications for growth, inflation and asset prices.

Banks are crucial for money but not for credit

In *Solid Ground: The day the maestro died* (July 2010), we noted that the banking system provides only about 22% of private-sector credit. The point was that banks are not that important in the provision of credit, but they remain vital to the creation of money. Under the factional-reserve banking system, banks create deposits when they extend credit. So if we lived in an environment where corporate repayment of banks loans produced a decline in total bank credit, then the change in bank balance sheets would produce a reduction in deposits in the system.

Corporate borrowing from banks has stopped declining

The good news is that this is not happening. As at 18 August, commercial & industrial (C&I) loans at US commercial banks totalled US$1,241bn, which is the same as on 9 June. While there is no sign of corporations borrowing more from banks, there has also been no sign of deleveraging over the past couple of months. This data is aligned with the results from the Federal Reserves Senior Loan Officer Survey of July 2010. A few extracts from that survey below show how there are early signs of stabilising or improving demand for credit by corporations.

Banks are easing credit pricing for companies

- Domestic survey respondents reported having eased standards and most terms on C&I loans to firms of all sizes, a move that continues a modest unwinding of the widespread tightening that occurred over the past few years. Moreover, this is the first survey that has shown an easing of standards on C&I loans to small firms since late 2006. Significant net fractions of domestic banks also reported having eased their pricing of C&I loans to firms of all sizes. Banks pointed to increased competition in the market for C&I loans as an important factor behind the recent easing of

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terms and standards. Demand for C&I loans from large and middle-market firms and from small firms was reportedly little changed, on net, over the survey period after declining over the three months prior to the April survey.

Credit lines for companies are no longer being cut

- Domestic banks also reported that they had stopped reducing the size of existing credit lines for commercial and industrial firms, on net - the first time that banks had not reported cutting such lines since these questions were added to the survey in January 2009.
- A shift in customer borrowing to their bank from other credit sources and customers' increased financing needs for inventory and receivables were the most common reasons cited in the current survey by banks that had experienced higher loan demand. The net percentage of respondents that pointed to customers' increased investment in plant or equipment as an important reason for stronger demand for C&I loans also edged up relative to the April survey.

Bank loans will lag market credit as pricing is easier in the markets

The most recent data for C&I loans and the Senior Loan Officer Survey shows how corporate borrowing from banks has stopped declining. This of course could be temporary, but encouragingly the recent stability in C&I loans is just part of bigger picture of returning corporate-credit demand. C&I loans are concentrated among smaller corporations that cannot access the credit markets directly. Loan pricing is much more stringent than in the public markets and thus it is particularly positive that corporate demand for bank loans is stabilising. It suggests that loan demand is likely to be more buoyant for the bulk of corporate America, which can borrow in the more reasonably priced public markets.

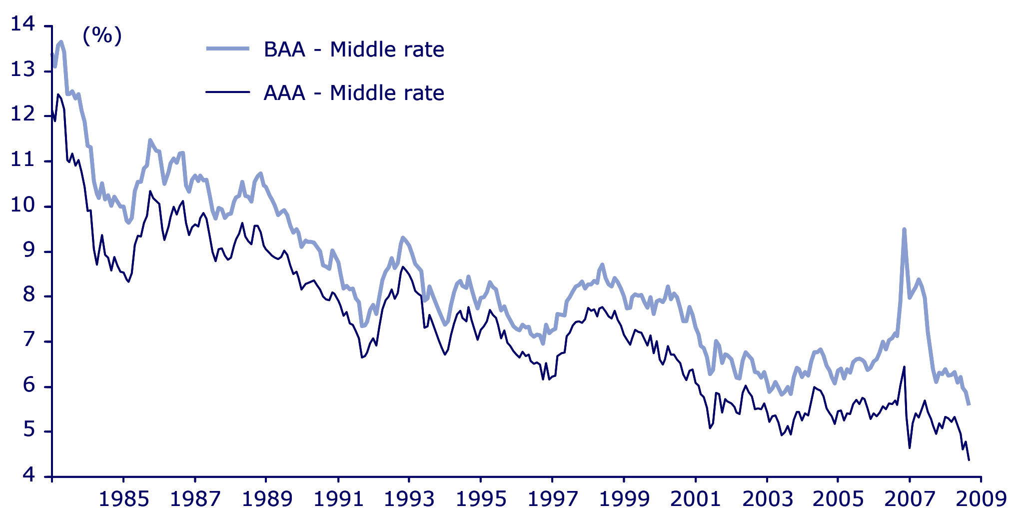
Signs of growing corporate credit in the credit markets

Nonfinancial corporations access three times more credit from commercial paper and corporate bonds than they do from bank loans. Thus trends in credit demand in corporate bonds and commercial paper can provide better indications of corporations demand for credit than bank loans. As Figure 24 shows, US corporations are able to borrow at incredibly low rates in these markets and thus are more likely to seek credit there as banks remain cautious in their lending activity.

Bond markets providing credit at record-low rates for the modern era

Figure 24

Moody's US corporate bond yields



Source: Datastream

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Nonfinancial corporations were increasing gearing as early as 1Q10

There is indeed evidence that nonfinancial corporations are currently increasing their credit demand by borrowing through the public markets rather than through banks. This is important as it shows that, at least in this sector, demand for credit has returned and, when banks are prepared to lend on better terms, that bank-loan growth will pick up. The good news is thus that nonfinancial corporations increased their borrowings in the public markets by US$118bn (11% growth annualised) in 1Q10 alone according to the Flow of Funds statistics. More recent data suggests that this trend has continued through 2Q and into 3Q. With borrowing growing, to what negative purposes can the US$2.3tn in nonfinancial corporate balances be put?

If companies do not use liquidity to repay debt, it will be used elsewhere

So if companies are not using their cashflow and hoarded deposits to pay down debt, what will they use it for? The following is a list of possible uses and it strongly suggests that the mobilisation of these balances will be to the benefit of growth, inflation and asset prices:

- Pay more for inputs including labour
- Invest in capital goods
- Pay more interest on debt
- Pay more in taxes
- Pay more in dividends
- Buy back shares
- Buy other companies

If companies pay more for inputs, inflation will be evident and investors will buy equities

If companies are forced to buy more or pay more for material inputs, it will be positive for equities. The price of material inputs is set by market forces and companies would have to pay more for these inputs if supply/demand conditions require it. If selling prices do not compensate for such rises then there will be negative impacts on margins and profits. Given the current high levels of cashflow, any margin squeeze would probably have to be significant before it would create a run down in deposit balances. Should corporations begin to pay more for their inputs this could be seen as positive for inflation if somewhat negative for margins and profits in the longer term.

Early-stage inflation has usually been good for corporate profits

As argued in Section 4, equities are pricing in a major deflation, which would seem a very unlikely outcome if companies begin to use their deposits and cashflow to bid up the prices of material inputs. The current supply/demand conditions do not suggest that companies will be forced to use their deposits in this manner, but if they do then it would be positive for equity valuations, as it would undermine the current belief in deflation. There will clearly be negative long-term implications if inflation gets to high levels. History suggests that inflation can rise to near 4% before equities react badly (see *Solid Ground: How the rally ends*).

Using corporate liquidity to hire more labour would allay fears of a double dip

Should corporations use their deposits to buy more labour or pay more to existing labour, it would also be positive for the equity market. As many fear a double-dip recession as employment growth and wage growth are sluggish, using corporate liquidity to increase employment or wages is likely to provide a boost to personal incomes and expenditure. At current valuations relative to bonds, any indication of continued growth and inflation would be very positive for equities.

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Using liquidity to buy more capital goods would also allay double-dip fears

A move by corporations to buy more capital goods would again be good for economic activity. The sluggish nature of investment recovery has been another key concern of those who believe in a double dip. If a stronger investment recovery develops, fears of a double dip and deflation will abate and the price of equities is likely to rise.

Higher borrowing costs could suck out liquidity but this is likely to happen slowly

US corporations are borrowing in the debt markets at record-low levels (see Figure 24). This cannot be sustainable in the long term. However, the current declines in Treasury yields are further reducing corporate borrowing costs. So there is no evidence that this trend is ending and history suggests that when it does end, the rise in treasury yields is likely to be slow. At a time when the public purse is clearly committed to preventing private default under the "too big to fail" policy and with corporate cash balances and cashflow at record highs, a dramatic widening of spreads is also unlikely. So while it is likely that a greater proportion of corporate liquidity will go towards servicing debt, this is likely to be a slow and gradual trend rather than a rapid mobilisation.

Corporate tax rates will rise, but slowly

As with the payment of interest, a material diversion of corporate liquidity to pay more tax would not necessarily be positive for growth and inflation, but as with the payment of interest, just such a diversion is inevitable. However, once again it is not imminent and no material rise in the effective corporate tax rate is expected in the next few years.

The bull case for equities is higher dividends, stock buybacks and M&A

The three remaining possible uses of corporate deposits and cashflow (dividends, M&A and stock buybacks) all involve returning cash to shareholders. Such a return is the quickest route to materially higher equity prices. It is the nature of the current institutional marketplace that returning cash to shareholders causes that cash to be reinvested in equities. An investor whose chosen equity exposure is compulsorily reduced through such a return of cash will be predisposed to reinvest that cash to return their equity exposure to their desired level. Perhaps less so than companies but certainly more than individuals, there is an institutional dynamic that limits the ability of professional investors to hold cash. Once an individual trusts his capital to an institution, there is a simple dynamic against deposit accumulation.

Mobilisation of corporate liquidity is highly likely to be good for share prices

It is difficult to foresee how equity prices could go down from current valuations if corporations decide to use any or all of these methods to return cash to shareholders. Mobilising corporate deposits by paying them to shareholders would thus be very positive for equity prices and asset prices more generally. It would also help to instil confidence in a recovery and rebuild personal balance sheets on a way to more robust consumer growth.

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If the Swiss don't want a strong exchange rate, who does?

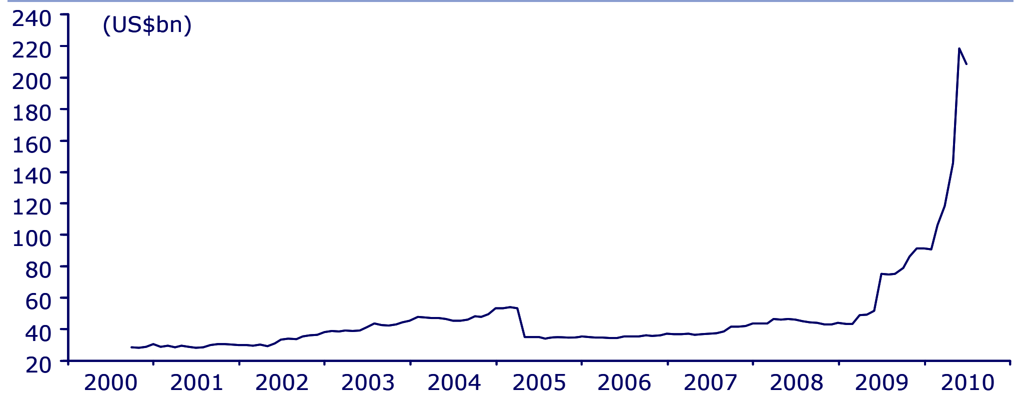
Rather than let the Swiss franc rise in value, just create more Swiss francs

More money than chocolate = inflation

The investment business is always straightforward in hindsight. In years to come it will be seen that the current activities of the Swiss National Bank made it clear that we faced an inflationary future.

Figure 25

Foreign reserves of the Swiss National Bank



Source: Datastream

Sterilisation has a poor record and risks are being taken with inflation

There once was a time when you could count on the Swiss to be against inflation. As Figure 25 demonstrates, this is no longer the case. Today the Swiss have joined a very long list of authorities who have decided that the risk of inflation is better than a strong currency. Sterilisation of such intervention may help, but there is considerable research suggesting that it does not work. Even against a background of sterilisation, this move is taking risks with inflation that the Swiss have historically shunned.

Emerging markets do not want higher forex rates; this will not change soon

We have lived with just such policies from the emerging markets for almost a generation, and against a background of massive labour mobilisation since the fall of the Berlin Wall it has produced little inflation. That dynamic is now changing (see *Solid Ground: China's structural inflation*) and the Swiss adoption of the same policy has added fuel to the fire. Investors need to ask a crucial question as they make the call between inflation and deflation: If nobody wants a strong exchange rate, how can we have deflation?

Even in the 1970s there was a bastion of hard money, but not anymore

Emerging markets have spent many decades fighting exchange-rate appreciation and in the process have run looser monetary policy than they otherwise would. The USA and the UK opted for a quantitative-easing policy to ease monetary policy conditions and happily ignored the impact such printing of money would have on their exchange rates. Investors took fright at such policies and rushed for the Swiss franc as a safe haven.

More inflation follows when exchange rates are artificially depressed

And then the world changed. The Swiss refused to let their exchange rate find its own level and have run a looser monetary policy than they would otherwise have done.

History will show that the Swiss pointed the world towards inflation

Who is next? Already it seems the strength of the yen has brought Japan to the verge of intervention. But if no country will let its exchange rate rise to its market level then it will not do so. If the guardians of global money cannot devalue their currencies against each other, then they must inevitably devalue them against goods and services. When the history books are written, it will be seen that it was this unwillingness to accept the consequences of a strong exchange rate that made it obvious that our future was inflationary and not deflationary.

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Conclusion

Equities are pricing in recession and deflation. Indeed they could be at fair value relative to bonds if earnings declined by two thirds. This is at a time when a postwar-record deleveraging of the US private-sector appears to be ending and as an unnatural hoarding of deposits in institutions seems to be coming to its inevitable end. It is a pricing for recession and deflation that ignores the rush to prevent the revaluation of exchange rates and the inevitable inflationary dynamic.

It is time to buy US equities and enjoy the last major rally of the 2000-14 bear market that investors are likely to witness. The bear market in bonds has just begun. In due course it will have negative impacts for equity valuations, economic growth and earnings. However, such a denouement probably remains a few years in the future.

The 1970s was a terrible time to buy and hold equities, but it also produced some of the best one-year holding periods for these instruments. Another such great opportunity now presents itself for the nimble and the bold.

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