►On Target

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What's Likely to Happen in Europe

The Eurozone farce is a game of pass the parcel… with the "winner" to be left holding the booby prize.

Somebody has to pay the costs of allowing Greece and other troubled member-nations to loot the single-currency system through indulging in profligate lifestyles and speculative real estate booms, accumulating a mountain of debt they cannot afford to repay. But no one is willing to pay…

The **populations** of the troubled nations are hostile to giving up the advantages they have enjoyed and continue to enjoy such as overpaid public-sector jobs and early retirement, and angry about having to pay higher taxes and suffer cuts in their public services to meet the costs of debts seen as largely benefiting wealthy elites and foreign banks.

The voters of more responsibly-managed member-nations such as Germany, the Netherlands, Finland, are equally hostile to paying to save the irresponsible countries from the painful consequences of their behaviour.

The **banks** and other financial institutions are using their considerable political influence to avoid facing up to the huge losses that will be involved if they have to "mark to market" their enormous dodgy loans to the governments and private-sector borrowers of the troubled countries.

The European Central Bank, having loaned an enormous amount to private-sector banks – €100 billion to Greece alone – to ward off financial crisis, is terrified of the consequences if such a crisis erupts nevertheless. Not least to its own reputation. And it's furious about the failure of governments, which have allowed the situation to fester and failed to come up with a solution.

As for the **politicians**… They are twisting and turning as they seek to dodge the bullets and avoid having to make the hard decisions about who is going to have to pay to clear up the mess.

They cast around for scapegoats (such as the credit rating agencies), seek to hide the scale of the bad debt embedded in European banks and other financial institutions, and now even confess to lying to the public to avoid scaring the horses. No wonder financiers call this a policy of "extend and pretend".

The core of the developing crisis in the Eurozone is that undercapitalized banks

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are supporting over-indebted governments by holding (and buying more) of their bonds; those same governments in turn have to support troubled banks; and there is insufficient equity (asset value) in the banking system to meet potential losses, so creditors grow nervous – especially as it becomes clearer that they are going to be forced to carry a significant share of such losses.

The European Central Bank finds itself having to provide liquidity on an open-ended basis to the banking systems of peripheral member-nations, steadily weakening its own balance sheet.

One surprise is that more of the individual investors in the banks of Southern Europe have not already withdrawn their deposits and moved their savings elsewhere. If the owners of capital lose confidence, and start a panicky flight to safety, that would precipitate a European (and global) financial crisis.

Greece is at the centre of the developing storm because it is seen as the country most likely to default on its debt. Its scale is already enormous -- €350 billion -- and continuing to mount as its government borrows even more to finance current spending, including interest costs, far in excess of revenues.

It cannot afford to pay the rates of interest lenders demand for providing more credit. And its financial circumstances are so extreme that it seems most unlikely it will ever be able to repay outstanding loans when they mature. Barclays Capital estimates that the scale of spending cuts and revenue increases that would be necessary to eliminate the debt problem is three times greater than the maximum that is achievable, economically and politically.

A nation notorious for its corruption, with a public sector bloated with people who got secure jobs because of whom they knew, rather than what they are competent to do, is responding to pressure from Eurozone authorities to reform by making promises they wriggle to avoid delivering on.

So far the austerity being imposed from abroad has cost 250,000 jobs in the private sector, but none in the politically-protected public sector.

Financially Greece is on life support, the only sources of new credit being other Eurozone governments, the International Monetary Fund, and extremely reluctant foreign banks whose arms are being twisted by their governments.

This won't solve the problem, because it just adds more debt to a debt burden that is already insupportable.

And the crisis is spreading across the Eurozone. What is likely to happen?

Here are the potential outcomes...

More patch-ups: The European Union and the IMF reluctantly provide more money, the nations on life support agree to meet tougher conditions, the European Central Bank pumps additional liquidity into national banks.

Everyone hates what they are forced to agree to, but prefer "kicking the can down the road" to making the even harder decisions needed to restructure the Eurozone and refinance its enormous debt on a sound basis.

Advantages: Avoids the financial crisis that would be triggered by a default; gives the Eurozone time to negotiate, legalize and implement a centrally-controlled fiscal structure; gives Greece's economy more time to adjust; allows time to develop structures that impose burden-sharing on the private sector.

Disadvantages: Reduces pressure on governments to produce a permanent solution, stokes the risk of a political backlash, and allows the Greeks to continue making promises they do not expect to be able to keep.

It also encourages the private-sector banks to dump their toxic credits and potential capital-flight problems on to taxpayer-funded entities and the European Central Bank. It does not alleviate the problem of rising market-determined interest rates worsening troubled nations' fiscal problems.

Restructuring: Before the crisis gets out of control, the Eurozone evolves a package of measures. That would provide for a continuing flow of aid to troubled member-nations over a long period such as ten years to give them time to address their problems of fiscal haemorrhage and lack of international competitiveness.

The package would have to be financed by borrowing, probably running to more than a trillion euro, either directly in the form of Eurozone bonds, effectively underwritten by Germany, or indirectly by national governments that would then have to finance their contributions through increases in their own borrowing.

This would be the "transfer union" concept that alarms voters and politicians of the Northern nations, providing for the transfer of wealth from the strong to the weak, from the financially responsible to the irresponsible, on a systematic basis.

But it would undoubtedly be underpinned by the introduction of a centralized European treasury to control revenue collection and spending by national governments.

Building a sounder foundation for the future

Advantages: Governments, voters, wealth owners and banks all have to face up to the realities of solving the problems of European toxic debt and poor governance.

That would remove the danger of financial crisis and so strengthen Europe's economic foundation, stimulating regional growth, living standards and job creation.

Disadvantages: It will not solve the problems inherent in individual troubled economies such as Greece. They will be unable to adjust enough to become competitive and to service a huge burden of debt without the "easy fix" of devaluation of currency to boost exports and discourage imports. It will worsen their fiscal problems already brought about by recession and sluggish global recovery, enforcing even greater austerity.

The burden will tend to be focused on the less-wealthy, as it takes the forms of unemployment, small-business bankruptcies, and higher taxes of the hard-to-evade type such as those levied on consumers – with politically-destabilizing consequences such as the rise of radical parties.

It will force nations to accept the passing of more of the key elements of sovereignty to a centralized bureaucracy in Brussels.

Unplanned default: It could be triggered by a shock development.

For example, one of the strong member-nations, their voters in rebellion at giving even more subsidies to finance the soft jobs, living standards and fiscal irresponsibility of others, use the courts to force their government to veto a commitment to provide/authorize further assistance.

Or by the collapse of the Greek government and its replacement by anti-euro forces. They might choose the Icelandic Option (after refusing to bail out its banks, that island nation has been able to return to credit markets to borrow at a reasonable cost), default on state debt, exit the Eurozone, and revert to Greece's old currency, the drachma, using a favourable conversion rate.

Or there could be some other unexpected development that interrupts cash flows to those governments on financial life support.

Facing a threat of systemic disaster, the European Central Bank would turn on its "printing" machine and offer unlimited credit to banks, temporarily abandoning all considerations about the quality of the collateral required.

Advantages: Precipitates urgent measures to restructure the Eurozone, recognize asset losses on national and bank balance sheets, and allocate losses to private-sector creditors.

Although the Greek economy would be plunged even deeper into recession, forcing even more painful adjustments to reality, it would quickly stabilize and start a sustainable recovery driven by a stimulatory exchange rate.

Another Lehman disaster? No ways

Disadvantages: Contagion spreads to Portugal, Ireland, Spain… then Italy. Triggers a European financial crisis, with runs on banks by frightened creditors. That might force governments into extreme measures such as nationalization of banks, more extensive guarantees of bank deposits, probably capital controls.

It would spread across the globe because of the network connecting Europe to the rest of the world economy, one example being nearly a half of US money-market assets being deposits in European banks.

However, the scary talk about there being a repeat of the 2008 Lehman crisis looks extreme. Lehman was a disaster because it was so unexpected for the US government to refuse to rescue a major bank. If/when Greece defaults, few people will be surprised. So… limited shock effects.

Planned default: Eurozone governments and the ECB agree to allow Greece to cease making payments on part or all of its government debt through conversion into relatively cheap Eurozone bonds.

Greece is allowed to exit the zone temporarily, (reviving the drachma), and re-enter later with much lower costs in euro terms.

Advantages: Much less messy and damaging than an unplanned default (makes contagion effects less severe because markets are forewarned and given plenty of time to adjust), provides a permanent solution to the problems of uncompetitiveness and debt burden, and forces the Eurozone to introduce fiscal centralization.

It ends a situation where the ECB is forced to weaken its balance sheet and credibility by providing unlimited "liquidity" support to contain unresolved solvency problems.

Disadvantages: Some dangerous contagion effects nevertheless. Serious damage is done to public trust in the ECB and private-sector banks as it becomes clear how much their balance sheets are stuffed with dud or dodgy assets.

All the banks forced to recognize their losses on those assets will have to raise huge amounts of capital to restore reserves to acceptable levels. Long-term savings institutions such as pension funds will also be forced to adjust to big losses on their supposedly low-risk investments, reducing benefits and raising contribution rates.

Interest rates will go much higher as private-sector creditors require much higher rates of return to offset their greater risk of enforced “haircuts”.

These are the potential outcomes. What are the probabilities?

Because of the intensity of conflicting interests, and the very poor calibre of political leadership, I expect to see more patch-ups. Governments will continue to avoid taking the hard decisions.

But as the costs of the patch-ups escalate, and market pressures and turbulence mount, there will be increasing risk of unplanned default. If that happens, it will force the European Central Bank to act, “printing” as much money as it needed to prevent systemic seizure.

Disaster will be avoided. But the scale of the crisis will force governments into restructuring Europe as a fiscally centralized nation. United Europe (or most of it), will hold together and emerge stronger.

So… delay, then a major crisis, followed by renewal. That’s my road map.

Gold: “Imminent Transition” to Price Acceleration

Gold should be the “central module” of an investment portfolio because of its defensive characteristics, relatively attractive value and good prospects, the Vienna-based Erste Bank argues in an extensive new report.

Here are a few of the many interesting points it makes…

The comeback kid: Long despised almost unanimously as a “barbarous relic,” gold is starting to regain its traditional role in the global monetary system.

Europe’s Commission for Economic & Monetary Affairs has decided to accept it as collateral. Investment bank JP Morgan already does so. World Bank president Robert Zoellner has argued for restoring gold to some role as a “reference point,” while US Federal Reserve governor Thomas Hoenig has defended the old gold standard as a “legitimate monetary system”.

As for central banks… They’ve stopped selling gold and have started accumulating it in their reserves once again. Last year they were net buyers for the first time in two decades.

The rival to paper money: Since 2007 the Fed, the European Central Bank and the Bank of England have inflated their balance sheets by more than $4½ trillion. In that environment, “investors like to head for the safe haven”.

Interest rates are negative in real (inflation-adjusted) terms, and are likely to remain so, or at least low, because raising rates would have a catastrophic impact on US government finances. We can expect the “financial repression” that punishes savers and eases the burden on debtors to continue.

Positive real interest rates are bad for gold, and explain the 20-year bear market of the 1980s and 1990s. By contrast, negative real rates constitute “an optimal environment for gold”.

Positive characteristics: Gold isn’t precious because it’s scarce, but because annual supply of additional metal from the mines is so low relative to the existing stock. Global reserves are only growing at a rate of 1½ per cent a year, or at about the same rate as world population.

This low ratio of production to stock is the characteristic that differentiates gold from other commodities and from fiat (paper) money, offering “stability and safety”.

Diversification: Numerous studies prove that having gold in a portfolio reduces overall risk and improves performance. It is “not subject to any form of liquidity risk, its market risk is lower, and it does not contain any credit risk.” Gold doesn’t need to pay any interest because “it does not contain any counterparty risk”.

It’s portfolio insurance providing an efficient hedge against “black-swan events and against tail risk.” The bank gives the historical evidence proving it.

Various studies have shown the benefit of a gold weighting of 5 to 10 per cent in a portfolio.

Price targets: Using the same formula that was used to fix the Bretton Woods’ official gold price, and using the growth of the US monetary base since those days, suggests a “shadow gold price” or realistic valuation today of almost $10,000 an ounce.

The bank says: “This figure illustrates the magnitude of monetary inflation already embedded in the system, sitting latent and threatening to increase the general price level”.

Many other calculations support the view that the gold price “still has substantial upward potential.”

Relative to measures such as growth of money supply, peaks in other commodities such as oil, intensity of media coverage – even the price of beer at the Munich Oktoberfest -- the gold market is definitely not yet in a bubble phase, but is “a stable bull market”.

Institutions to dominate next stage of the bull market

Investment demand: This is increasingly driven by investors in China and India. In the first quarter retail demand doubled in China compared to 12 months before, as many Chinese desert the overheated property market and seek protection against inflation.

Longer-term, because Asians have a strong affinity for gold, rising living standards will produce growing demand for the yellow metal.

But – the bank predicts: “Institutional investors will dominate the next stage of the gold bull market – especially insurance companies and pension funds”.

Already there has been the pioneering example of the University of Texas’ endowment foundation taking physical delivery of $1 billion worth of gold.

There is huge potential in central banks. Although many of the “old rich” countries such as the US have substantial gold reserves, the “new rich” emerging economies do not. Among the countries with negligible gold reserves are those with gigantic holdings of foreign currencies – China, Korea, Japan, Brazil, Singapore.

Although exchange traded funds have accumulated a lot of metal that they are holding for investors, there is now some nervousness about ETFs as a whole. Consequently "we are witnessing a shift from paper gold investments to the real thing".

A huge naked short position: According to one estimate, central banks have loaned to hedge funds, mining companies and others somewhere between 12,000 and 15,000 tons of gold, equivalent to about six years' mine production.

If rising prices trigger what would effectively be a covering of short positions, that could lead to an explosive increase in gold prices.

The miners: They are now facing a vast array of new taxes and licence fees. This means that "selection of the right jurisdiction has become one of the most important criteria for gold share investments." The six most favourable are the Canadian provinces of Quebec, Ontario and Yukon, Chile, the US state of Nevada, and Western Australia.

The boom has driven mining into much lower grade deposits. The average gold content of ore mined worldwide was more than 8 grams a ton in 1950; it's now one-tenth as much.

Costs are another problem. Cash costs reached an average of $558 an ounce last year and are rising annually by 10, 15 per cent, even more. All-in costs have probably gone up to an average of more than $1,100 an ounce.

Valuations are low by historical standards

Shares v. metal: The gold price has risen much more strongly than gold mining shares recently, probably because of a leap in mining costs (especially energy), the "very expensive" business of terminating hedging programmes, and investor preference for ETFs, where they aren't exposed to any operational risk.

The bank also says that management of major mining companies has been poor, with too much reliance on expensive acquisitions to provide growth, and too little importance given to return on assets, return on equity, and dividend payments.

Dividend yields remain unattractive. The absence of willingness to distribute a higher proportion of profits is "one of the most striking negative features of the mining sector".

The current payout ratio is only about 19 per cent, compared to 52 per cent for the financials sector, 67 per cent in the energy sector and 80 per cent from utilities. "Only the technology sector has worse payout ratios than gold mining stocks," although some big groups have recently improved their dividends.

Nevertheless, gold mining shares are currently valued attractively. The 16 companies in the Gold Bugs index offer an average price/earnings ratio of 14 times, expected to fall to 12 times in 2012, which is "extremely low" by historical standards and relative to those of other sectors.

Technical analysis: The upward trend in gold prices is "intact across all time lines," says the bank, with Fibonacci theory suggesting a medium-term price target of $2,000. The public opinion indicator confirms that sentiment remains cautious, which signals that “there is hardly any euphoria priced in”.

The positioning of speculators does not indicate euphoria but rather a gradual increase in optimism – “a reliable signal for further significant upside potential”.

Seasonally, the gold price is about to move into a positive phase. Over the past decade it has risen two-thirds of the time in September, more than in any other month (the next most favourable months have been November and December).

Conclusion: Long-term comparisons of gold relative to other asset classes – and the extent of the current debt crisis goes much beyond the situation when gold soared to a peak in 1980 – supports the views that gold is in “imminent transition to an accelerated trend phase” likely to culminate in euphoria.

Tech Stocks Head the Field

America’s tech-heavy Nasdaq 100 “has been the clear leader” among developed market indexes over the past few years, says *Fullermoney*’s Eoin Treacy, “not least because its major constituents are heavily leveraged to the growth of the global consumer.

“A significant number of the index’s best-performing shares have either been focused on cloud computing or on the cutting edge of healthcare” – both sectors with the capacity “to introduce cost efficiencies which were not previously available, and therefore can create value”.

He lists shares, many of which “continue to display leadership credentials and exhibit some of the more consistent uptrends” – Apple, IBM, Amazon, Google, BMC Software, Check Point Software, EMC Software, Citrix Systems, Oracle, Salesforce.com, Teradata, Cognizant Technologies, Juniper Networks.

However, established tech companies such as Apple and Google were conspicuous laggards in the second quarter, with investors preferring newcomers such as Zynga, LinkedIn and Facebook.

Samsung Electronics, the world’s largest tech company by sales, expects second-quarter earnings to fall by about 26 per cent compared to last year, with losses in the TV and traditional computer sectors overshadowing strong sales of smartphones and tablet computers.

Investors aren’t treating old-school tech companies as growth stocks any more, says Paul Bard of Renaissance Capital.

By one measure, price-to-earnings ratio, American tech stocks are at their cheapest compared to the rest of the market in almost 20 years, with Intel and Microsoft trading at PEs of below 10x forward earnings, Apple on about 12x and Google below 14x.

However, that isn’t an appropriate yardstick, argues GTI fund manager Iain Little. “What’s the point of using [it]… to measure a tech stock’s attractions when market share and earnings change so typical of technology are so febrile?”

“How do you relate a stock’s price (market cap.) to a single annual earnings number when you have plus 85 per cent annual growth? Not even a PEG (PER to earnings growth) ratio can keep up with that rate of change”.

The famed Warren Buffett “doesn’t touch tech for its short product cycles and low barriers to entry. I can see why”.

Poor Education to Blame for Unemployment

Although a university education is promoted to young people as a way to boost their lifetime earnings power, in fact it creates “very little value,” argues one of America’s most successful fund managers, Bill Gross.

College fees in the US are now, relative to the prices of goods and other services, four times greater than they were 25 years ago, yet the education provided is “stultifying… outdated, overpriced and mismanaged.” So much so that hedge fund luminary Peter Thiel is now giving $100,000 grants to teenagers who drop out of school and start their own businesses.

Gross blames university administrators, who “have a talent for increasing top-line revenues,” but “lack the spine necessary to upgrade academic productivity”.

The primary culprits are professional tenure (jobs for life), and “outdated curricula focusing on liberal arts – instead of a more practical global agenda focusing on math and science”.

Universities are “run for the benefit of the adult establishment… not students”.

The average American college graduate leaves school with $24,000 of debt – student loans now exceed the nation’s total credit card debt. He/she “can no longer assume that a four-year degree will be the golden ticket to a good job in a global economy that cares little for… social networking skills, and more about what their labour is worth on the global marketplace”.

Commentator Fareed Zakaria argues that the schooling system, instead of prioritizing the liberal arts, should focus on technical education and “mimic the German path, which allows people with good technical skills but limited college education to earn a decent living”.

Gross says the huge number of unemployed and under-employed Americans includes millions of jobless college graduates ill-trained to compete in the global economy.

For decades the US has allowed its manufacturing base to erode, with production of hardware gravitating to foreign economies where workers are willing to make excellent products for one-tenth the wages of Americans.

Reliance on wealth creation via financial services is now approaching a dead end, leaving the US “untrained, underinvested and overindebted relative to our global competition”.

The millions of unemployed are not just victims of a cyclical weakness in the economy, but also of a structural weakness produced by internal neglect as well as foreign competition.

“Over the past ten years, under both Democratic and Republican administrations, only 1.8 million jobs have been created while the available labour force has grown by over 15 million”.

Good Ideas to Boost Growth

Writer Peter Coy has scanned the world for some positive ways to "fix" the US economy, which remains sluggish despite unprecedented financial stimuli. Here are several he's identified:

► In Germany they've avoided housing booms and busts by only allowing highly qualified buyers to get a mortgage loan. Down payments are usually at least 20 per cent, sometimes as much as 40 per cent. Mortgage interest isn't deductible when calculating personal tax liability, as it is in the US (that encourage excessive leverage).

"Germans are justly proud of their Pfandbrief, an ultra-safe bond whose collateral is a set of standardized mortgages whose loan-to-value ratio can't exceed 60 per cent," Coy reports. "The bank that sells a mortgage-backed Pfandbrief to investors retains all the risk of default, giving it the incentive to underwrite cautiously".

► In Turkey foreign investment is encouraged by having a single point of contact for all permits, licences and land acquisition. The Investment Support & Promotion Agency, with a multilingual staff, also co-ordinates specialized training for the workers that multinational companies need, and arrange for tax breaks.

► Several countries have jobs credit programmes to encourage employers to keep workers on their payrolls through times of economic crisis. In Singapore this policy meant that in the 2009 world economic crisis unemployment was held down to just 3.3 per cent.

The island state also has its Skills Programme for Upgrading and Resilience, known as SPUR, which pays companies to train workers who are idle, instead of laying them off, even for jobs in sectors where the employer doesn't do business.

Human Rights, Persian Style

The head of the Iranian judiciary's human rights council, Mohammad-Javad Larijani, has defended stoning to death, the amputation of hands or feet, or blinding as punishments "based on Islam and our constitution".

He claims that the sentence of stoning is much lighter than one of outright execution because "the defendant can actually survive".

At a recent conference he defended Iran's savage punishments with a counter-attack on foreign critics, accusing Westerners of making "a mockery of the partnership between a man and a woman as a family unit by saying that two men or two women… homosexuals… can live together as life partners; so based on this analysis, in the near future a human being will be also allowed to marry a cat".

Westerners criticize the stoning of adulteresses, yet "do not even speak out against a woman who cheats on her husband and produces an illegitimate child".

Larijani defended retaliation and punishment as practised in Iran as "beautiful and necessary things" to protect the rights of individuals and of a people. "The executioner or the person carrying out the sentence is in fact very much a defender of human rights".

Tailpieces

Investment trusts: These closed-end funds consistently deliver better returns than comparable mutual funds according to new research by the Lipper group, because their annual charges are about half a percentage point less. That can make a dramatic difference over time.

For example Aberdeen New Dawn investment trust delivered a return of 480 per cent over the ten years to the end of May, whereas the similar Aberdeen Asia Pacific, a mutual fund, delivered only 323 per cent.

David Fuller comments that he has long preferred the closed-end funds as, in addition to their lower fees, they can be bought and sold as easily and instantly as shares, and usually trade at a discount to their net asset value.

However, although the older investment trusts generally have low fees, some of the more recently launched ones operating in the infotech sector have considerably higher ones. If you're thinking of buying into them, check the charges before you decide.

Fewer teenagers wanted: This is proving to be a rotten summer for young Americans to find a job, with the proportion of 16- to 19-year-olds at its lowest since record-keeping began in 1948.

Only one in four have jobs. "Instead of learning valuable job skills – getting out of bed before noon, showing up on time, being courteous to customers, operating a cash register or fork lift, millions of kids will spend the summer playing computer games or hanging out," is *The Wall Street Journal's* cynical comment.

Main reason for the shortage of vac jobs is the lousy economic recovery. But foolish policy measures have magnified the problem. Over just two years a Leftist-dominated Congress raised minimum wages from $5.15 to $7.25 an hour – a big discouragement to businesses to hire more unskilled labour.

Over the past 12 months average hourly earnings for all those in employment have increased only 1.8 per cent, to $23, or only half the rate at which consumer prices increased.

Rebalancing China: Although America is escalating its pressure on China to allow its currency to strengthen in dollar terms, there is much evidence that would do little to reduce China's foreign trade surplus with the US. Longer-term, much more important will be rises in wages and prices in China, boosting domestic consumption.

Meanwhile, with China's foreign reserves now topping $3 trillion, much of it held in assets fast losing value because of the depreciating dollar, the Beijing authorities are giving greater priority to putting its trade surpluses into sounder investments. Two senior government economists are reported as saying that China doesn't need foreign reserves of more than $1 trillion.

China's exports hit a new record in the first half of the year of $874 billion, up nearly 20 per cent on last year, despite a strengthening in its exchange rate in dollar terms, factories' rising costs from inflation and government-directed wage increases, and difficulties in key markets such as Japanese supply-chain disruptions.

Chinese companies are rapidly adjusting to changing circumstances “by moving production to cheaper inland labour markets, retooling factories with automation, and expanding into higher-value goods such as electronics,” reports Alex Frangos.

Property opportunity: One sector of the US real estate market that some analysts are bullish about is rental housing. “Americans will now want to rent, not buy, as they are fast learning to appreciate the flexibility that comes with not being trapped in negative equity,” comments CLSA strategist Christopher Wood. Nearly a quarter of home-owners with mortgages now owe more on their loans than the market value of their properties.

However, this is a longer-term opportunity for investors, as for the moment the excess supply of housing makes it easier for tenants than landlords to secure good deals.

Debt destruction: Governments erode their debt burdens through “financial repression,” argue economists Carmen Reinhart and Belen Sbrancia. Keeping the interest rates they pay on their long-term bonds well below the growth rate of their economies has a persistent and major effect of lowering debt ratios relative to economic activity.

For example, says PIMCO’s chief Bill Gross, if US savers receive an average 2 per cent on their Treasuries, while the economy grows at an average rate of 5 per cent in nominal terms, then a debt-to-GDP ratio starting at 116 per cent falls to 112 per cent after one year, then to 109 per cent the next year, and so on.

The historical experience in the period that began in the mid-1940s, when the US and the UK used negative real interest rates to destroy the burden of national debt that arose out of the depression and the world war, was that 30 to 40 per cent of the debt disappeared in the course of a decade.

Rising protectionism: “Neither American nor European education has changed sufficiently to reflect the need for better and more flexible skills with which to counter Asian competition,” says commentator Russell Taylor in *Money Management.*

“Instead, governments are becoming populist and nationalist, competing to reduce the value of their currency in order to boost their share of exports, and so make up for the loss of domestic demand from higher taxes and job losses.

“These are the beggar-my-neighbour policies that made the 1930s depression so long-lasting”.

Bonds and the dollar: “In the bond markets it is better to hold bonds of great companies than bad governments,” says Investment Research of Cambridge.

“In the short term, however, the US is still by far the biggest economy and the dollar the world’s major currency.” So if equity markets “go into risk-off mode, then the dollar will rally strongly”.

Not that tough: Although British finance minister George Osborne has been accused of making an “audacious gamble” in enforcing cuts in state spending, “if anything, the reverse is true,” argues commentator Allister Heath.

“For all the talk of austerity, the spending figures show the government to be every bit as fiscally incontinent as its predecessor. Every month spending has been, on average, 5 per cent higher than the same month in the last year of [Labour premier] Gordon Brown. The national debt is rising fast…"

Debt financing: One important difference in government finance between America and Japan is that about half of US Treasury bonds are owned by foreigners; almost all Japanese government loan stock is held by Japanese citizens. Foreign ownership weighs heavily on interest-rate decisions made in the US. It can be ignored by policymakers in Tokyo.

Inflation: I loved this caustic comment from Jürgen Stark, a director of the European Central Bank, that judging inflation by using the "core" metric, which excludes prices of items that vary according to supposed temporary factors, such as food and energy, is "well suited for central bankers… who don't eat or drive" (at their own expense, of course).

The value in paper money: And this one, by Kenneth J Gerbino: "If you don't trust gold, do you trust the logic of taking a pine tree worth $4,000-5,000, cutting it up, turning it into pulp, putting some ink on it… and then calling it one billion dollars?"

Wise words: *The inherent vice of capitalism is the unequal sharing of the blessings. The inherent blessing of socialism is the equal sharing of misery.* Winston Churchill.

Martin

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