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Debt Crisis Explosion: Still a Long Way Off

Endgame, John Mauldin's much-praised book on "the end of the debt supercycle and how it changes everything," is an excellent backgrounder to the changed global environment in which we now have to invest.

The problem is debt. Too much of it. Debt "gets to the point where something has to give," Mauldin says. The inference is that we're close to a major crisis. And the markets may be ignoring the danger, just as they failed to anticipate the catastrophic First World War.

Commonly-quoted debt ratios such as 80, 100 or even 200 per cent of GDP seriously underestimate the scale of the problem because they ignore countries' legal commitments to pay the huge future costs of pensions and medical care for ageing populations.

And the time left to do something about that, by raising retirement ages and reducing benefits, is running out because of the growing political power of the beneficiaries to resist such cuts. Within a decade the elderly will constitute more than half of all voters in Europe and North America.

Policymakers are deeply divided over what to do to deal with the problem of excessive debt.

"The Federal Reserve and central banks in general are currently attempting a major and highly experimental operation on the economic body, without benefit of anaesthesia," Mauldin says.

They are "testing the theories of four dead white guys: Irving Fisher (representing the classical economists), John Keynes (the Keynesian school), Ludwig von Mises (the Austrian school) and Milton Friedman (the monetarist school)."

The crisis could still be a long way off. Martin Barnes of Canada's highly-respected BCA consultancy, which originally developed the concept of a debt supercycle, says we're nowhere near the end of it yet.

We're not yet experiencing the global deleveraging that produces another great depression, as the bubble of total debt continues to inflate, with government debt rising much faster than private-sector debt is falling.

Currently "governments can print money and borrow like crazy without provoking inflation because of slack in productive capacity created by the recession."

We have the absurd current situation, where investors are prepared to pay

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governments to look after their money – negative interest rates in some cases, with negative real (inflation-adjusted) rates commonplace.

But that cannot last. At some stage, “you run out of suckers to buy government debt,” as Mauldin puts it.

Lots of nasty things are likely to happen, sooner or later:

► Defaults – and not just by deadbeat nations such as Greece. In the 1930s both the US and the UK took actions on their government bonds that penalized investors and amounted to defaults.

► Currency wars as countries seek to limit strengthening of exchange rates or even reduce them in “a race to the bottom.” Latest example: the Swiss central bank’s announcement it would “print” an unlimited amount of francs to cap its exchange rate relative to the euro.

► “Financial oppression” – governments “will use a variety of means to force investors to buy government bonds” and seek to reduce the value of their liabilities through inflation.

How to invest for deflation, then inflation

Although Mauldin’s book is most informative, even entertaining, it ends up being unsatisfying in two ways.

His recommendations about what investors should do to survive and prosper in the developing crisis are negligible, accounting for just two pages in a work of almost 300, although he is probably correct in forecasting the future as: “Deflation first, and then inflation.”

We should invest accordingly. For the initial, deflation phase, he says buy:

Treasury bonds (the book is written for an American audience);
Income-producing securities;
The dollar.

For the following inflation phase, buy:

Precious metals;
Inflation-protected and short-duration bonds;
Commodity currencies such as the Canadian loonie, New Zealand kiwi, Aussie dollar, Brazilian real and Norwegian krone;
Companies supplying basic materials, energy and consumer staples.

But my fundamental problem with his book is with his equivocation on the key issue facing investors for the next few years – the extent to which there is going to be money printing, and its likely consequences.

Mauldin says (page 230) that as central banks generally are overwhelmingly more concerned about deflation than about inflation, they will be “extremely loose with their monetary policies” and “continue to flood the world with money.”

However, he also says (page 202) that, “even given the recent bout of QE2,” (money printing), “it is hard to conceive of the Fed” (the American central bank) “actually monetizing” (printing money to buy new issues of Treasury bonds), so allowing “the US government to run large deficits.”

Why would the Fed, which has been among the world's leaders when it comes to easy-money policies, suddenly reverse direction so sharply, adopt Volcker-style restraint, and do the opposite of other central banks?

Why would American financial policymakers, who have been so generous with their massive support for mega-banks, insurance speculators, uncompetitive industrial giants, overcommitted mortgage loan borrowers – even foolish foreign mega-banks – refuse to accommodate the biggest wasteful spenders of the lot, their own political class?

As the global economy struggles to fend off recession, central banks – including and especially the Fed – will provide even larger doses of money.

They won't solve anything. But they will delay further, and eventually worsen, tackling the fundamental problem of too much debt.

Mauldin says that "excess liquidity" created by quantitative easing and similar central bank policies, being money surplus to the needs of economies for their productive purposes, tends to flow into asset markets such as stocks, bonds, commodities and property.

So more money printing will be favourable for many investments. Mauldin's endgame will come, eventually… but not for quite a while.

Endgame, by John Mauldin, is published by John Wiley & Sons, ISBN 978-1-118-00457-9, at $27.95.

An Unexpected Stock Market Leader in Asia

The Philippines stock market recently surged to a new all-time high, after the nation's government was able to raise $1½ billion of 25-year money at a record-low yield of 5 per cent, the offer being oversubscribed more than eight times.

These are strong signals that international investors are starting to take a serious interest in this Asian country, long neglected because of its history of political instability and indifferent economic performance.

Following its recovery from the Second World War, the Philippines was regarded as Asia's most promising economy after Japan.

The optimism evaporated after the arrival of the Marcos dictatorship in 1972. International investors came to the conclusion that, as one analyst puts it: "Everything falls apart in the Philippines if the politics goes wrong."

But for years now, the nation's political climate has looked better. Investors are starting to focus once more on its fundamental strengths.

These include a population of more than 100 million known around the world for their friendly dispositions and, especially, their competence in English, which is the principal language of instruction in the schools of this former American colony.

About one-tenth of the working population are employed abroad, especially in the US, the Mideast and elsewhere in Asia, as construction workers, maids, seamen, nurses. The money they send home to their families is a major driver of the economy, accounting for 10 per cent of GDP.

But increasingly Filipinos are being employed in their own country to operate call services and provide many other kinds of business services.

A huge pool of reasonably-educated English-speaking labour is available. The universities alone are churning out 400,000 new graduates every year. And they are cheap. Qualified accountants, for example, can be hired for as little as $1,000 a month.

Business processing outsourcing (BPO) has become an important catalyst for growth of the Filipino economy, with some 300 multinationals buying services there and employing two-thirds of a million workers.

And it's growing fast. Last year BPO earned the nation more than $10 billion, or half as much as came in through remittances by Filipinos working overseas. This huge inflow is forecast to reach about $25 billion a year by 2016.

The surge in BPO is driving up demand for office property in Manila, Cebu and proximate boom towns to accommodate expanding work teams.

Another -- new -- growth factor for the economy is a massive programme of investment in infrastructure.

For long the Philippines lagged in this area. Over the five-year period 2006-10, capital investment accounted for only 16 per cent of economic activity, compared to 20 per cent in Malaysia, 25 per cent in Thailand and 27 per cent in Indonesia.

Now the government plans to spend $17 billion over the next five years on toll roads, airports and mass transit rail systems, using public-private partnerships.

The economy is in good shape to handle strong expansion. Its growth rate has averaged 5 per cent a year over the past decade. Improving state finances have reduced fiscal deficits to low levels, with the annual figure heading down towards 2 per cent of GDP next year.

Forex reserves now exceed total foreign debt. The national currency, the peso, has strengthened moderately against the dollar. Inflation is no problem (at least, not yet), and bond yields have been falling.

Because of the relatively small size of the stock market, international funds have

East Asia's Middle-Weight Economies

	Indonesia	Malaysia	Philippines	Singapore	South Korea	Taiwan	Thailand
Stock market % change US$ '12	4	-3	4	-16	-10	-24	-4
Economy US$ bn forecast '12	989	292	267	281	1245	518	381
Living standards GDP per head US$	3,990	10,050	2,570	52,220	25,010	22,170	5,540
Economic growth % GDP forecast '12	6.3	4.4	4.0	4.0	3.7	3.0	4.2
Population millions	248	29	104	5	50	23	69

been wary of investing. But that is an advantage for individual investors, who don't have to worry as much about tradeability of shares. Increasing foreign interests will broaden the market, in turn drawing in some of the big money.

Here are some possible opportunities…

Deutsche Bank and iShares both have **exchange traded funds** listed in the UK, Germany, the US and Singapore offering exposure to the Filipino market. There are **mutual funds** listed in Luxembourg, Hong King, Singapore, Japan and the Philippines itself.

If you prefer direct investment into individual listed stocks, here are three worth investigating:

Ayala Corporation (AC:PHS), the nation's biggest conglomerate, has a diversified portfolio of interests, a respected brand and a well-regarded management team. Its chart looks good. There's an ADR listed in New York.

SM Development (SMDC:PHS) is a fast-growing residential property developer focusing on condo units for the higher end of the middle market, nearly all of whose projects are in Manila. Its earnings-per-share growth has averaged 30 per cent a year over the past five.

Jollibee (JFC:PHS) has 717 fast-food outlets throughout the country, and some 67 overseas. It has a good chart and consistent earnings growth, with a well-covered dividend. It also has a New York-listed ADR.

CLA Asia-Pacific strategist Christopher Wood says the Philippines is now "a very promising story." With bank lending growing strongly across a wide range of sectors, after years of post-Asian-crisis deleveraging it "increasingly looks like it could be where Indonesia was five years ago, in terms of the potential for a multi-year credit and investment cycle to kick in."

Europe's Club Med Bank

The "solution" to the Eurozone debt crisis is turning out to be what I forecast it would be, although it's arrived even sooner than I expected – money printing, and on a massive scale.

The European Central Bank is now under the effective control of citizens of nations hungry for cheap, easy credit -- the president is an Italian, his deputy is a Portuguese, with Latins and a Belgian holding five of the six executive directorships. It's the Club Med Bank.

One of the first actions of new president Mario Draghi was to offer an unlimited amount of new three-year credit to European banks. They signed up enthusiastically for the equivalent of $645 billion of cheap loans.

There will be another window of opportunity to borrow on February 29. Market speculation is that banks could go for $1 trillion, perhaps even more.

The Club Med Bank has also agreed to accept higher-risk securities as collateral for its three-year loans. This particularly helps the stressed French banks.

The generous money-lenders at the ECB's Frankfurt headquarters clearly hope that banks will use some of their additional resources of easy credit to lend on to

their governments, which face a huge refinancing problem on their maturing bonds, and need a lot of extra dosh to finance their continuing over-spending.

Lending three-year money to banks, with the option (suggestion?) they pass on a lot of it to their governments, is a clever and probably effective way for the Frankfurters to circumvent the specific prohibition preventing the ECB from lending directly to governments.

Why aren't the Germans, Europe's guardians of fiscal responsibility, kicking up a big fuss over this Club Med manoeuvre? Clearly because they would rather see the Latins provide unlimited credit than provide subsidies financed by their own taxpayers, or get into nasty rows about fiscal restraint and a Brussels-based fiscal dictatorship.

The Germans, says commentator John Mauldin: "While they still growl and bark, like any well-trained dog, they stay in the yard… allowing the ECB to prop up banks throughout Europe." But it's more than "prop up," John. It's providing a new, massive supply of heroin to the addicts.

I have long argued that the big problem with central banks' policies of providing such abundant, free or nearly-free credit, is not that it will produce runaway inflation, but that when we get strong recovery in the world economy (probably five to 15 years in the future), and general inflation does start to emerge, it will force central banks to make an agonizing choice.

Either they will have to start boosting interest rates to prevent runaway inflation, or drag their feet and allow it to happen. Either way a sharp rise in the cost of capital would stop the economic recovery in its tracks.

Currently the US Treasury, for example, is able to borrow ten-year money by issuing bonds costing just 2 per cent. The strategists at the RiverFront Investment Group say: "If the US had to borrow ten-year funding at 6 per cent, it would add about $400 billion annually to our deficit, an increase of approximately 30 per cent."

Moneycraft: Questions to Ask

Citiwire's Lorna Bourke says that before choosing a personal financial adviser you should check if he/she is professional and expert, asking these five questions:

► How do you make your money? Fees alone, fees plus commission, salary plus commission, just commission? In the UK, "fees will probably be around £150 an hour, which means you need to be relatively wealthy to make it worthwhile."

However, "free" advice from a commission-based adviser is never really free – you really pay, one way or the other. "For example, it's cheaper to pay a fee of £1,000 for advice than to allow an adviser to clock up 3 per cent or more commission on transferring a £100,000 pension pot."

Other advisers are tied to specific investment houses and only advise on their products.

► What qualifications do you have? The gold standard is being certified by an appropriate professional body in the US, the UK or other country with advanced investor protection.

► Do you understand my requirements? “Make sure the adviser knows your attitude to risk and takes a record of your financial background and your expectations.

“Get a written explanation of how much the advice will cost, and payment options.”

► What’s your area of expertise? It’s only human for an adviser to have some bias towards the kinds of investments he/she knows best. A good one, lacking expertise in a particular area, will refer you to an appropriate expert.

The greater the complexity of your affairs and range of potential investments, the more it makes sense to use several specialist advisers, rather than one generalist.

► Who will be handling my affairs? “Be aware that with larger firms you may be seen initially by a partner or director, but unless you are particularly wealthy, your account will probably be handled by a junior – ask to meet that person.”

Optimism about China

Its strong financial position gives the Chinese government room to stimulate the economy when it is ready to do so, suggests CLSA Asia-Pacific strategist Christopher Wood, as “public-sector debt is still running at only about 35 per cent of GDP,” including local government debt. Even including borrowing by the State Development Bank only takes total public-sector debt to about 44 per cent of GDP.

He says “a major buying opportunity is coming in China” when the government eases its squeeze on property and bank lending. With inflation continuing to fall, “feedback from the well-connected is that a property easing could come as early as the second quarter.”

Chinese shares have been looking really cheap, with the CSI 300 index trading recently on a forecast 2012 earnings ratio of only eight times.

The threat to Chinese banks from non-performing loans is no immediate risk, as all the evidence is that “defaults will be avoided for now through the extension of maturity [of loans] and forbearance on the part of creditors.”

What about the policy issue of promoting consumer demand to reduce dependence on exports and investment?

No matter what changes are made to the exchange rates of China’s currency, or to its interest rates, they won’t have any major impact raising the share of personal consumption in the Chinese economy, argues Yukon Huang, a former director in China for the World Bank.

Writing in *The Wall Street Journal*, he says the three reasons for the plunge in the share of consumption in economic activity to 33 per cent – a remarkably low proportion by international standards -- are:

► Urbanization. “Workers have moved from less productive agriculture, where labour’s share of the value of production is almost 90 per cent, to more-capital-intensive industry, where labour’s share is only 50 per cent. “This transformation accounts for about 80 per cent of the decline in the share of household income in GDP over the past decade.”

► Depressed interest rates. Through state control designed to assure abundant cheap resources to finance capital investment, savers lose out.

► Saving is given priority over spending. Chinese families are big savers because of poor welfare benefits, need to provide for retirement, and the culture of buying household equipment for cash.

But, Huang says, the most important reason for high savings is that migrant workers, who now account for half the labour force in many coastal cities, lack the formal residency rights, called *hukou*, that allow them access to public services.

That is a strong incentive to save for personal setbacks. "Savings rates of migrant workers are much higher than those of established residents – as much as twice as high in some cities."

If migrants had *hukou* rights in the urban areas where they work, they would have greater security, so they would save less and spend more.

That would be much more effective in promoting personal consumption and correcting China's imbalance in its foreign trade than raising the value of the yuan.

Global Strains: Wealth Tax Ahead?

The financial system could be heading for even bigger shocks, particularly in places such as the UK, Hong Kong and Switzerland, says a new paper by three Bank of England economists.

"Faced with further increases in the magnitude and/or volatility of capital flows, it is likely that some countries will choose to introduce capital controls," they warn.

With a combined debt level for advanced economies of 180 per cent of GDP for governments, private households and non-financial corporations, giving a debt overhang of $11 trillion for the US and €6 trillion for the Eurozone, some governments may be tempted to impose "a one-time wealth tax of 20 to 30 per cent on all financial assets," suggest David Rhodes and Daniel Stelter of the Boston Consulting Group.

Three "structural roadblocks" hamper global economic growth, says Pimco fund management chief Bill Gross:

► Globalization has hollowed out the labour markets of the developed nations, with so many jobs shifted permanently to the growth economies;

► Technology has outdated entire industries that produce physical as opposed to "cloud"-oriented goods and services, "the most recent dinosaurs" including books, music discs, postal letters and DVDs;

► Ageing population structures now favour savings as opposed to consumption in almost all developed nations.

Green Fuels: Costly, Unpopular

Some interesting points from an American investment banker specializing in the energy sector, Allen Brooks…

► Although US Congress has at last ended the ridiculous subsidy paid to farmers and refiners to make ethanol, which cost taxpayers $45 billion over its 33-year life, it has been replaced with a higher mandate forcing use of the alcohol fuel equivalent to 15 per cent of petrol supply.

So consumers will pay instead of taxpayers for a policy of dubious environmental value. It takes 1,700 litres of water to produce one litre of ethanol, as well as 60 kg of nitrogen fertilizer and 23 of phosphorus for each acre of farmland growing the corn used to make the fuel.

► Sales of electric vehicles are turning out to be disappointing for their boosters and a huge burden on taxpayers.

Last year General Motors sold only 7,000 of its Chevy Volt, most of which were bought by government units and GE, whose chairman is a prominent supporter of President Obama and his green agenda. Each sale was achieved through federal and state incentives to "green" industry, such as battery plants, costing an average of $250,000 a vehicle.

Research shows that some 40 per cent of potential car buyers in the US would be interested in buying a plug-in vehicle… if the price is right. Which they aren't, despite a federal tax credit for buyers of $7,500 apiece. The average family income of Volt buyers is $170,000 – not your typical car buyer.

Tailpieces

Autonomies: American, European and Japanese companies currently have a record stockpile of $7¾ trillion in cash or equivalents, according to the Institute of International Finance.

Why so much? One reason is shortage of attractive expansion opportunities in a poorly-performing global economy. Another is that corporate treasurers want plenty of resources available to protect their businesses, and maintain dividends, given the uncertain outlook for profits.

In the US real net corporate investment in capital stock – investment less depreciation – has now fallen to levels last seen in 1975.

Another sign of financial strength is that many of the best companies – dubbed Autonomies by the well-known analyst David Fuller – are regarded by the credit default swops market as safer bets than national governments and banks, especially in Europe.

Their huge resources provide firepower for a big surge in investment in expansion when (or if) there is a recovery in confidence in the future.

Signals switched to green? The stock markets of four Asian countries – Indonesia, Malaysia, Thailand and the Philippines – are "among the global leaders in terms of stock market recovery," says *Fullermoney*. They are seen as "speedboats" because of their linkage to a renewed surge in demand for commodities and industrial components by China.

The newsletter expects sentiment about China to turn positive this year, delivering a better year for emerging markets and resources plays in general.

Profit predictions: The consensus forecast of analysts for earnings growth this year for listed companies is nearly 10 per cent for the US and 8 per cent for Europe.

However, Peter Oppenheimer of Goldman Sachs points out that such forecasts at the start of a year are a hopeless guide. Not once in 26 years have American or European analysts predicted falling profits, although that's what happened in almost a third of cases.

Red tape: In the US for years the number of new "economically significant rules" – those costing more than $100 million a year – proposed, planned or being imposed on business, used to be relatively stable at about 70 to 90 a year. After 9/11, driven by security considerations, the figure jumped to around 100.

Since the Obama-Pelosi political takeover, business has been hit with an avalanche of paperwork relating to new policies on healthcare, financial services, energy, housing, education and student loans, telecoms, labour relations and transportation, pushing the annual total to 150.

One reason why the US economic recovery has been so disappointing is this blizzard of red tape that now burdens companies, raising their costs, much of it needlessly.

Earthquake risk: Japanese scientists now say there is a 70 per cent chance of a major earthquake within the next five years striking the Kanto region, where Tokyo is located, based on their analysis of a more-than-fivefold jump in the frequency of relatively minor temblors since the unexpectedly savage quake that caused last March's tsunami.

When that happens, the shock to global investment markets will be massive. Japan's economy is hugely important (it's still the world's third largest). Its overseas assets total some $3 trillion – a big chunk would be transferred back to Japan to pay for rebuilding after such a nuclear-scale shock.

National debt: In 2001 Switzerland led the way towards fiscal responsibility by introducing a constitutional requirement that the central government must balance its budgets. That has held down national debt to a remarkable 36 per cent of GDP, compared to 88 per cent in the Eurozone.

Germany followed the Swiss example by introducing a strict rule in 2009, which requires a balanced budget by 2016. That's one reason why it's so opposed to runaway fiscal deficits in Eurozone nations.

Investing for "binary risk": The future looks as if it will "either be considerably better, or considerably worse," argues *FT* commentator Tony Jackson. So "making money will be a tough proposition."

Standard Life, "a survivor from the old Scottish school of prudential investment, recommends being overweight in US and UK equities, corporate bonds generally, and the US and UK real estate."

Nil returns: A new study by three American academics shows that investors received no return from the average hedge fund over the period 2004 to 2009, because published figures showing positive returns ignored losses in funds that shut down.

Mortgage stress: Since early 2006 home owners in the US have lost more than $7 trillion in the value of their properties, according to a new paper by the Federal Reserve. In the latest quarter for which figures are available, the net value of mortgaged homes relative to owners' disposable personal income fell to a record low of 54 per cent.

Big boys get an easy ride: Regulation isn't very effective in preventing investors from being exposed to risk from the dishonest or simply incompetent, as we see repeatedly – especially if they're big, highly-respected fund managers.

In this context I noted this perceptive comment by New York lawyer Bradley Simon explaining how Bernard Madoff got away with his Ponzi scheme for so long: "The more powerful you are on Wall Street, the less likely you're going to be scrutinized."

UK dottiness diary: A customer at Waitrose, a high-end supermarket chain, was not allowed to buy a couple of bottles of wine with her groceries because she was accompanied by her three children, the youngest aged 13. The company has a policy of refusing to sell alcohol to anyone accompanied by teenagers unless they have identification. Carrying personal identification documents is not legally required in Britain, nor commonly done.

The road to success: Stimulation of the private sector through a range of policies was the key to recovery of nations such as Brazil in Latin America's crisis in the 1990s, Fidelity Worldwide Investment's Dominic Rossi reminds us.

"Asset sales, price liberalization and fiscal consolidation focused on expanding the private rather than the public sector. I do not recall the Brazilian central bank ever buying government bonds."

Greenback pessimism: The collapse of the dollar as the bedrock of the international monetary system is "inevitable," argues British gold bull Jim Slater, because the US national debt has risen to $14 trillion and the unfunded liabilities of social security and Medicare combined are now more than $100 trillion – "how can this be financed without further devaluation?"

Gold preferred: Indian families would much rather invest in physical assets, such as property and gold, than in equities. A recent bank study showed that households own about a trillion dollars' worth of gold, or seven times as much as they have invested in shares.

The entitlement bubble: An unhappy by-product of a welfare state is that it creates powerful interests that will fight to the last to preserve their free lunch, no matter the cost to the country, comments *The Wall Street Journal*. "The lesson of Italy, and most of the rest of Europe, is never to become a high-tax, slow-growth, entitlement state – because the inevitable reckoning is nasty, brutish and not short."

Starting your own business: Difficult times are perfect ones for "explosive growth… when the giant trees fall in a forest, it's new shoots that fill the gaps," says the well-known commentator John Mauldin.

"Did you know that the Great Depression created the largest number of new business millionaires in America?"

Sarkozy on Merkel: According to leaks emanating from France, not reported in the French press, but revealed by British columnist Rod Liddle in *The Spectator,* the following is what French president Nicolas Sarkozy responded when visiting US president Barack Obama asked him conversationally (in private, of course): "What world leaders do you really hate?"

His reply: "That German hag. You know, I half believe those Internet rumours that she was created from the frozen semen of Adolf Hitler.

"And have you seen her at dinner? Watch later on. She eats like a dinosaur, a big dinosaur, cramming stuff into that fat German gullet like they've just abolished rationing. Keep an eye on your filet mignon, Barack."

Wise words: *Bull markets do not die of old age; they are assassinated by central bankers.* David Fuller.

Martin

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