►On Target

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Fake Debt and Funny Money

The US Federal Reserve's policy of buying debt instruments with money it's creating out of thin air – currently at the extraordinary rate of more than a trillion dollars' worth every year – is the right thing to do, because it doesn't add to the net amount of US debt outstanding, argues the famous mega-speculator George Soros. "It's about as close to a free lunch as you can get."

What's he talking about? Is he right?

He is certainly correct that the growth in public debt in the US and other major nations – contrary to the obsessive interest in the subject by conservative commentators and almost all the financial media – is of no importance in itself.

It is a free lunch for the political classes, as it provides resources for governments to continue over-spending. Supposedly, that's to stimulate economic growth. But in practice it allows them to pursue their particular concerns, such as sustaining mega-banking and vote-rich zombie businesses, promoting the global warming mania, and spreading around enough welfare to keep the lower orders politically anaesthetized.

Public debt is a straw dog. Ordinary folk instinctively realize that too much debt is bad, because personal debt is a painful burden. It encourages them to give their reluctant support to politicians who say they want to contain the growth of public debt.

This distracts almost everyone from the real scandal -- which is money creation on a mindboggling scale. As ordinary folk cannot "print" money, they don't understand the process and its consequences. It even seems vaguely OK (wouldn't it be nice if we could do that?)

Public debt isn't the danger. The bubble in money supply is.

Much of the large and still fast-expanding public debt is fake. It's not real. It can be made to disappear overnight. The experts know this, but don't want you to know what's coming down the line.

Let me explain…

According to the investment bank CLSA Asia-Pacific Markets, this year the Fed will pour more than half-a-trillion dollars into buying US Treasury bonds. Money raised from the private sector and others (mainly foreign central banks) will finance only about 40 per cent of the fiscal deficit, with all the rest, 60 per cent, financed with Fed "bubble money."

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Although Fed holdings of Treasury paper still only account for 15 per cent of US national debt, the proportion is rising fast, mainly because the private sector/foreigners are losing their enthusiasm for Treasuries. Increasingly, the Fed is having to "print" money to buy the stuff.

The US is following the trend set by central banks elsewhere. In the UK the Bank of England now owns 28 per cent of government bonds; in Japan, it's about 40 per cent.

Those holdings are an important part of those scary debt-to-GDP ratios that financial conservatives, and politicians posturing as financial conservatives, keep quoting to frighten us into supporting the policies they favour, especially austerity.

But they are not true debt. They are what one agency of the state, the treasury, owes to another agency of the state, the central bank. (Yes, I know the US Fed is technically a private bank, but the reality is quite different; and elsewhere central banks are clearly state-owned).

By a simple legislative act, a nation's parliament can cancel the state's liability to itself at any time, wiping out the fake debt. The scary public debt ratio would plummet.

It gets better (for the ruling elites, that is…)

The rest of a nation's public debt is genuine in that it's what the state owes to its private citizens and foreigners who own its bonds.

But there is nothing to prevent governments that control their own currencies, as most of them do, from discharging those genuine debt liabilities denominated in their national currencies, over time, or in a crisis, by borrowing the money from themselves – their central banks – to pay them off.

They can convert genuine debt into fake debt, then make the latter disappear as if by magic.

Just a matter of time before it starts happening

There are reasons why major nations haven't done this yet. But the probability is that they will be driven into doing so in time, as global economic growth remains sluggish, governments fail to implement the radical reforms needed to kick-start higher growth, annual borrowings required to finance fiscal deficits stay high, and the private sector becomes increasingly unwilling to lend money to governments at derisory rates of interest.

Admitting that much of the national debt is fake, and scrapping it by act of congress or parliament, seems so shocking to most people that they can't believe it will happen.

But is there any reason to believe otherwise, given the track record of the ruling classes in recent years?

Those are the people:

► Who over-stimulated, then failed to restrain, a credit bubble whose bursting brought the world to the brink of economic disaster;

► Whose policies of dealing with the consequences clearly prioritize their own financial, ideological and sociological interests;

► Who have clearly already abandoned traditional principles of fiscal responsibility by embracing the "unconventional" practices euphemistically dubbed "quantitative easing" – primarily explosive money creation.

The immediate problem is not debt, fake or real, but political failure to focus on stimulating economic growth, private-sector business prosperity, and job creation.

The longer-term problem isn't debt, either – it's bubble money.

Creating money on a seemingly unlimited scale is supposed to stimulate economic recovery, but it's very ineffective at doing that. As the well-known British economist and commentator John Kay puts it: "The public at large feels little benefit, sees little stimulus.

"The reason is that the objective of monetization has not been to put money in the hands of consumers and businesses, but to put money in the vaults of banks."

The obsessive focus on national debt diverts attention from that real problem, which is all that funny money… which will eventually lead to explosive inflation, with potentially catastrophic consequences.

The money creation is a poor substitute for what needs to be done to boost economic growth, a failure rooted in fundamental disagreements among policymakers in the West about what's required.

Both sides are right… and wrong

The big divide is between the "Keynesians", whose beliefs are based on the Depression-era views of the great British economist John Maynard Keynes, favouring greater public spending, and the "Austrians" or "Austerians," whose school of thought is rooted in the views of Ludwig von Mises and Friedrich Hayek, directed towards recognition of, and destruction of, bad debt.

The Keynesians have got it right that this isn't the time to focus on austerity and fighting the build-up of public debt. It's a time to deploy state power to underpin national economies. If we can regain vibrant economic growth, that in itself will solve most of the immediate problems of fiscal deficits through boosting tax revenues and cutting welfare costs relating to unemployment.

But they've got it wrong in wanting to raise taxes impacting on wealth creators, in failing to focus state spending where it is most effective in promoting economic growth, and in opposing structural reform of unaffordable entitlement systems.

The Austrians have got it right about the foolishness of bubble money, where all the evidence suggests it will continue to fail to stimulate economic growth, while stoking long-term risks. And they're right about the madness of raising taxes (a negative for economic growth), and about the need to reform entitlement systems.

But they've got it wrong in focusing on national debt levels (the wrong target), and in promoting austerity at a time when the need is the right kind of stimuli to lift economic growth, which is the key to reducing fiscal deficits.

There is no agreement between the two conflicting schools of thought on compromises that would maximize economic growth while minimizing the inevitable sacrifices.

Markets were recently taken by surprise by the release of minutes suggesting that the Federal Reserve's committee that drives the liquidity creation policy is turning cautious… that the flood of easy-money causing the bubble in investment assets could be brought to an end earlier than expected.

But, as one commentator puts it: "The lesson of recent history is that the Fed's so-called 'hawks' have no effect on policy." That's determined by Ben Bernanke and his allies who are committed to "printing" until it delivers strong economic growth.

So there's a high probability that policymakers in America and elsewhere will continue to do the wrong things. Bubble money will continue to inflate. Global economic growth will continue to disappoint. Values of assets – particularly tangible, ungeared ones – will continue to inflate.

Invest accordingly.

A Future of Sluggish Growth

Structural headwinds may reduce real economic growth "not only in the US, but in developed economies everywhere," even below a "New Normal" rate averaging 2 per cent a year, argues the well-known investment commentator Bill Gross, top guy at Pimco, the world's biggest bond manager.

Those headwinds are:

► The debt burden and deleveraging: It's forcing governments to embrace austerity. In their now-famous study, economists Carmen Reinhart and Ken Rogoff concluded that over 200 years, once a country sees its official debt to GDP ratio rises beyond 90 per cent, economic growth slows by nearly 2 per cent for an average duration of nearly a decade. By their measure, the US ratio has already risen to about 100 per cent.

The developed world's binge on borrowed money has been on such a scale that "we may need at least a decade" to reduce debt to acceptable levels.

► Globalization: Technological advances have boosted economic growth, but "machines and robotics have rather silently replaced humans as the US and other advanced economies have sought to counter the influence of cheap Asian labour."

Almost a century ago Keynes highlighted a "new disease" that he called "technological unemployment," where jobs can't be created fast enough to keep up with the number of jobs being destroyed by automation.

Today it's clear that workers are losing the race against machines. "Accountants, machinists, medical technicians, even [those who] write the software for 'machines,' are being displaced without upscaled replacement jobs."

In the US a structurally higher unemployment rate of 7 per cent or more "is the feared 'whisper' number in [Federal Reserve] circles.

"Technology may be leading to slower, not faster, economic growth, despite its productive benefits."

► Demographics: When a society exceeds a certain average age of its people, as is happening in almost all developed economies, there's a contraction in the

proportion in the “dynamic cohort” of those aged 20 to 55 – “the ones who form households, have families and gain increasing experience and knowhow in their jobs.” Ever-larger proportions are moving past the critical 55-year-old mark.

One consequence is lower rates of growth in productivity and employment.

Another is a greater emphasis on saving and reduced consumption. Those approaching their seventh decade need fewer cars and new homes, and almost none of them have babies.

Such low birth rates and a significant reduction in demand have imperiled Japan for several decades now. Many other developed economies will suffer a similar experience over the next few years.

“Demographic population changes are becoming a silent growth killer,” Gross says.

What investment conclusions can be draw from this?

Pimco argues these ongoing structural changes will favour commodities such as oil and gold, inflation-protected and high-quality municipal bonds in the US, and stocks of emerging economies not strongly linked to the dollar.

Those likely to suffer are the longdated bonds of the US, Britain and Germany, high-yield bonds generally, and the shares of banks and insurance companies.

“Investors should expect future annualized bond returns of 3 to 4 per cent at best, and equity returns only a few percentage points higher.”

Asian Labour Costs: They’re No Problem

The combination of plentiful competitively-priced, non-unionized labour in the southern states, low gas prices and plentiful natural resources, “make the US the new favourable location for the manufacture of technology- and energy-intensive goods,” argues Guy Foster, the strategist at Brewin Dolphin in London.

This is “exemplified by the location of new plants by a wide range of different manufacturers – Airbus is building a plant in Alabama, Samsung are manufacturing in Texas, and Apple has announced they will shift some manufacturing of Macs to the US.”

However, it can be argued that the handful of highly-publicized examples of manufacturing activity being shifted back to the US from Asia because of soaring pay increases in Asia, particularly China, gives a misleading picture.

A new study by the US Business & Industry Council shows record manufacturing imports into America, suggesting greater reliance on foreign production, not less.

Although Asia is no longer as cheap as it once was, “as a whole, it still has a mix of low-cost labour, infrastructure and stability to make it the most cost-effective manufacturing centre,” Alfred Romann argues in the *China Daily Asia Weekly*.

► “Thailand, for example, has fantastic infrastructure and enough support industries to make it a great location for the manufacture of complex electronics or cars.

“There has been no exodus of these types of manufacturers,” despite wages that are among the highest in the region.

► Indonesia is attracting manufacturers looking to benefit from a consumer market that, already large, will eventually become one of the world's biggest.

► China's coastal areas can now produce "almost any kind of complex product with precise and high-quality manufacturing," with easy access to global trade routes.

► Bangladesh, Vietnam and Sri Lanka are taking factories that need cheap labour away from the China mainland, Thailand and Malaysia.

"Almost no one believes rising wages will make a serious dent in Asia's competitiveness as a manufacturing base. Increasing integration and the possibility to manufacture even the most complex products in environments of relative political and regulatory certainty makes Asia an ideal manufacturing location," Romann says.

And labour costs are still very low. As recently as two years ago, manufacturing wages in China were only about 5 per cent of the level in the US, and in the Philippines, about 6 per cent.

Investing for income

Achieve growing returns with minimal risk by creating a policy of high-quality companies with a long history of steadily-increasing dividends, Arie Goren suggests on *seekingalpha.com.*

Unfortunately he limits himself to US stocks, ignoring the many attractive dividend plays in Asia. Nevertheless, his approach is interesting.

His selection is restricted to eight firms in the S&P 100 index in eight different industries (combining control with limitation of downside risk and diversification). He requires a dividend yield of 2.8 per cent or more, annual growth in dividend over the past five years, a trailing price/earnings ratio of less than 22, and a forward ratio below 15x.

This is the portfolio he suggests, with figures as in the third week of February:

Company	Industry	Ticker	Forward div.yield	5-year div.growth	Forward PE ratio
Exelon Corp.	Utilities	EXC	6.86%	3.6%	13.4x
Lockheed Martin	Aerospace	LMT	5.24%	23.1%	9.6x
ConocoPhillips	Oil and gas	COP	4.63%	10.0%	9.2x
Intel	Semiconductors	INTC	4.26%	14.1%	10.1x
Raytheon	Defence	RTN	3.71%	14.4%	9.7x
Microsoft	Infotech	MTSN	3.28%	14.9%	8.9x
McDonald's	Restaurants	MCD	3.28%	13.9%	14.8x
Norfolk Southern	Railroads	NSC	2.80%	15.1%	11.4x

Goren says: "A good time to start a long-term investment in a blue-chip company which has a long history of steadily-increasing dividend payments is when, due to temporary weakness, its dividend yield is historically high."

Dangers on the Frontier

Money has been flooding into notorious investors' graveyards, reports *Fleet Street Letter*'s Brian Durrant.

“The best-performing markets have been

► Greece (in default in all but name);

► Vietnam (which has failed to live up to the promise that it would be the new China, and experienced inflation of over 20 per cent last year);

► Dubai (the scene of a massively oversupplied property market);

► Egypt (in the grips of political chaos and in receipt of bail-out funds from Qatat);

► Romania (one of the poorest European countries, plagued with incompetence and corruption);

► And finally Argentina, for heaven’s sake (a serial defaulter with a record for arbitrary state confiscation, and inadequate investor safeguards).”

Durrant says these “may be brave contrarian plays, but it looks more like the rising tide of liquidity lifting all boats – including some pretty ropey vessels.”

He argues that investors are “playing with fire” by pouring their money into what are commonly called the frontier markets – “a world where insider trading is more or less officially tolerated, where company reports are not reliable, and official government announcements are not necessarily objective.”

The rally in dubious frontier markets “is not a reflection of a shrewd contrarian play, but a symptom of growing complacency and indeed recklessness among investors.”

Planning to Retire Abroad

Although affordable housing, food and medical care, as well as an exotic location and good weather, make retirement to foreign countries a seductive option for prospective expat retirees, it’s important to recognize the risks and to have a detailed plan to deal with them, say the highly-respected Thailand-based US-certified financial advisers Chad and Peggy Creveling.

“The Internet has made it possible to research the details of what an overseas retirement could entail, but not all [such] articles tell the full story.

“For example, how realistic is it to expect to retire in a foreign country for under $500 a month?

“If you’re thinking about retiring abroad, it’s important to consider not only what may be possible today, but also what might change in the future that could derail your plans.”

The Crevelings quote some examples given a British journalist of the difficulties that expats may face:

► Retirement income may not keep up with retirement costs, due to income levels being fixed, higher-than-expected local inflation, or a currency mismatch between income and costs.

► Lump-sum pensions may be used up unwisely on gifts to local families, land deals or other projects that don’t generate income.

► Higher-than-expected medical costs, no or inadequate private health insurance, and expat medical policies that discontinue at the age of 70.

[Not mentioned is the risk that capital is put into poorly-performing, unduly costly or inappropriate investments on the recommendations of the many moneycraft advisers located in countries to which expats move).

"It's important to develop a detailed plan and consider various scenarios before making the move. With proper planning and realistic assumptions, retiring overseas can be a rewarding experience – but one that should not be taken lightly."

The Crevelings can be contacted by email: info@crevelingandcreveling.com.

The Sage Changes Strategy

Warren Buffett's takeover of the Heinz food giant at such a high price in terms of multiples of earnings and book value suggest that he has deviated from classic value investing in favour of "quality," suggests the *FT*'s John Authers.

This concept "has various definitions, but usually means stocks with steadily-growing earnings… strong balance sheets… low price volatility and… yield."

The trend in the stock market for the past year or two has been to pay, or overpay if necessary, for "quality."

With $48 billion in cash "burning a hole in his balance sheet," the Sage of Omaha has been keen to do another big takeover.

In contrast to his acquisition of the Santa Fe-Burlington Northern railroad group, a bullish play on the US economy, Heinz is the opposite. It appeals because of its imperviousness to external conditions. "Come recession or boom, people will eat ketchup and baked beans," while its Weight Watchers brand "appears to be an economically durable business."

Commentator Tim Price says Buffett has "decoupled from the value investing philosophy that made him the world's most successful investor."

But then his reputation has been eroding for some time. One example is his well-known disdain for gold. Yet since 2000 its price has outperformed that of shares in Buffett's famous company Berkshire Hathaway by more than 300 per cent.

Close Your Eyes and Hope for the Best

California's local government pension funds are in serious trouble through a combination of absurdly-generous commitments made to employees, absurdly-optimistic assumptions about investment returns, and the need for massive top-up contributions at a time of collapse in local taxes because of the Great Recession.

One example: Glendale, a Los Angeles suburb, saw its annual pension-fund bill explode from $1.3 million in 2003 to $13.7 million in 2007.

So how are those guardians of public finances dealing with the problem? By cooking the books.

In the past, the CalPERS pension fund regulator used to calculate the level of contributions required from local governments for financial soundness on the basis of

average investment returns over three years. Then, from 2005, it allowed contributions to be based on returns averaged over 15 years, allowing unusually-high figures from the bubble years to cushion averages under pressure from recent poor results. In 2011 it went further, extending the basis of calculations to 30 years.

The US Congress also recently relieved the pressure on pension funding by allowing trustees to manipulate the interest rate used for calculating future liabilities, to make them seem smaller.

Paul Marsh, a leading London Business School researcher, says this is akin to a home-owner who, upon hearing of the approach of a hurricane, decides not to board up his house – but smash his barometer.

Better a Clown than a Bureaucrat

In Europe the ruling classes are only in favour of democracy when voters approve of what they want to do. When the public rebels, the political system is manipulated to defeat the popular will. An example is how referendums on constitutional changes within the European Union that don't deliver the "right" answer are circumvented, or referred back for reconsideration till they do.

This kind of trickery is becoming more difficult, and dangerous for political and economic stability, because of the stresses within the structure of the bloc require radical measures, but those require public tolerance – and solutions that don't allow the elite to escape most of the pain.

"The pay cuts, job losses, bank bailouts, pension reductions, benefit cuts, elimination of services, loss of perks and higher taxes required to restore competitiveness within the Eurozone are based on the assumption that citizens will accept them," says my friend David Fuller of *Fullermoney* newsletter.

In Italy, a ruling clique headed by a bureaucrat, Mario Monti, was foisted on the public without an election. The government lacked the democratic authority to impose various unpleasantnesses. So we shouldn't be surprised that when the public got their chance, they registered a huge protest vote, preferring a clown and bunga-bunga to a bureaucrat.

High-Growth Sector: Medical Tourism

Asia's emerging economies are giving increasing priority to attracting patients from abroad to their inexpensive but very high quality hospital services.

In Thailand, whose Bumrungrad hospital in Bangkok was the global pioneer of medical tourism, private hospitals, dentists' and physicians' groups and hotels have now formed an association to promote the country as a medical hub. Thailand already earns more than $4 billion a year from this business, having attracted more than 1.4 million foreign patients in recent years.

Typically packages on offer to faraway countries in Europe and North America include all medical costs, airfares, five-star hotel accommodation and a holiday for recovery from surgery.

Attractions include much lower costs, “queue-jumping,” some kinds of surgery not readily available in patients’ own countries, and in some cases higher standards of medical care (including much friendlier nursing).

In Malaysia, where the number of medical tourists has multiplied ten-fold over the past decade, they have established a dedicated call centre, MHTC Care Line, to answer enquiries from all over the world.

Health Minister Liow Tiong Lai says that typically total knee replacement at a top-class hospital in Malaysia would cost about $8,000 and a heart bypass operation only $10,000.

A big growth sector in Thailand is cosmetic surgery, where there are now some 350 specialist clinics. Popular treatments are breast augmentation, face-lifts, tummy-tucks, liposuction, Botox injection, dental whitening, hair transplant and vaginal reconstruction.

Tailpieces

Gold: Central banks bought a net 535 tons last year, the strongest level of official demand since 1964, with buying strengthening in the final quarter as the price softened.

There are also early signs of moves to restore gold to its historic role as money. In the US state of Utah, gold and silver coins are legal tender and some progress is reported in getting people to use them to pay for their purchases. In certain parts of Malaysia it’s now practicable to use the gold dinar and silver dirham for transactions. In Switzerland an initiative is under way to get 100,000 signatures that would authorize a referendum on bringing back gold as the foundation of the national currency.

Investment returns: Global bonds have delivered higher returns on average than global equities over the past third of a century, according to the latest annual study by the London Business School for Credit Suisse.

Another uncomfortable conclusion is that cheap money isn’t good for equities, as is commonly believed. Analyzing stock-market performance of 20 countries since 1900, the researchers show that low interest rates are usually followed by low equity returns over the following years.

They say investors ought not to assume average annual returns of more than 3 to 3½ per cent in real terms over the next 20 to 30 years. Investors planning to provide for their future retirement and pension fund managers should work on that conservative assumption.

Britain: Less austerity now, more of it after reasonable economic growth has been achieved, is Martin Wolf’s prescription for boosting the UK economy.

The *FT*’s commentator says that to reconcile capital markets to the idea of continued heavy borrowing to finance less austerity, the government should make explicit commitments to cut public spending in future, once economic recovery has been achieved.

He also urges the government to speed up structural reforms that might encourage higher investment by the private sector; make the banks own up to the scale of their

bad debt and recapitalize; and use current conditions of very low interest rates as "a once-in-a-lifetime opportunity for higher public investment."

Dead money: Why has the money bubble created by central banks not triggered explosive inflation (yet)?

Tim Price of PFP Wealth Management suggests three reasons:

► Most of it sits inert in the reserves of commercial banks, not circulating in the economy.

► Because the banks are in reality "pretty much insolvent… the last thing these firms are going to do is actually lend it out to anyone."

► There may not be much inflation in the economy, but "there is already uncomfortable inflationary leakage feeding into the prices of many financial assets, including… stocks and bonds."

Natural resources: One long-term factor that supports the bullish case for investing in commodities is that high development costs, including lenders' tougher demands, and political risks, discourage mining companies from expanding supplies.

An indication of that was last year's "capital strike," with the industry able to raise only $250 billion for capital investment in new projects and expansions, through initial public offerings and bank loans -- down 25 per cent from the previous year.

Polar bonanza gets under way: A major investment in the oil and gas potential of the Arctic – estimated by the US Geological Survey to contain more than a fifth of the world's undiscovered but probably recoverable reserves – is being made by the giant Statoil, two-thirds owned by the Norwegian government.

A $15 billion development centred on a terminal at Veidnes, a town at the northern tip of Norway, will start exploitation of the Skrugard and Havis fields under the Barents Sea. Initially about 200,000 barrels a day will be pumped ashore for shipment.

Norway is one of the world's major oil and gas exporters.

Which currencies to flee: Instead of worrying about Big Mac purchasing-power comparisons, or foreign trade and investment flows, to assess which currencies are likely to weaken, "investors and market speculators should analyze [official] promises, observe QE purchases as a percentage of GDP or outstanding debt, and sell the most serial offender or obsessive compulsive printer," says Pimco chief Bill Gross.

Favour the Lucky Country: Australia's long-term government bonds are preferable to those of any others right now because the strength of the currency, due to the central bank's relative hawkishness, which ensures a continuing deleveraging cycle in the domestic economy, given the still-high level of personal debt relative to disposable income, says the CLSA Asia-Pacific Markets strategist Christopher Wood.

Fiscal probity: Notwithstanding widespread pessimism about the European Union's inability to fix its fundamental financial problems, it's good to see that leaders at their recent summit negotiated a six-year budget of €960 billion, well below the €1,033 billion requested by the European Commission.

Still far too much, but at least the first step in the right direction.

China stocks: At prices of Hong Kong-listed mainland companies still trading on price/earnings ratios around 10x, somewhat lower than the five-year average of 13x, and now it's clear that China's economy is picking up momentum, this is "the

right time to invest" on the Hong Kong and mainland bourses, says Asset Plus Fund Management.

Meaningless gains: Profits are worthless unless they deliver real value. Over the last decade the world's best-performing stock-market has been Zimbabwe, but, as hedge-fund manager Kyle Bass has pointed out – at the end, owning the index would only buy you three eggs.

Wise words: *We hang the petty thieves and appoint the great ones to public office.* Aesop, Greek slave and writer.

Martin

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