

The Pain Report

From the desk of HFA Asset Management's Jonathan Pain

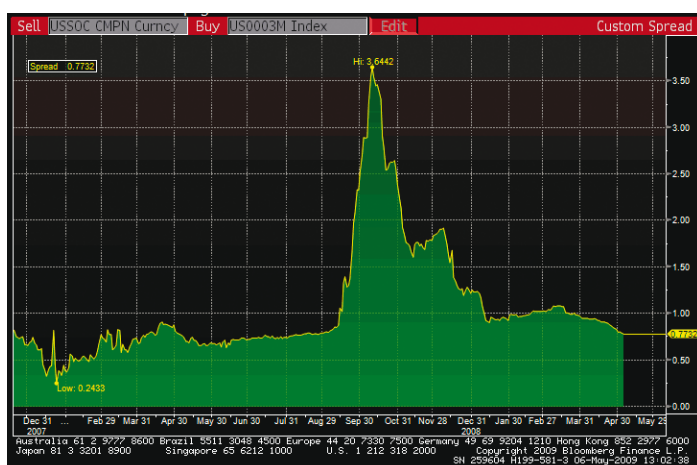
Searching for economic healing

'We appear to have avoided financial and economic Armageddon and markets have moved from pricing a deep depression to pricing a nasty recession'

Since our last Pain report Global Equity markets have performed very impressively and we have similarly seen a significant improvement in "risk appetite" across all asset classes. The process of healing continues throughout the capital markets and the "Armageddon" we faced in October 2008 appears to be fading like a very bad dream.

Chart one shows you the dramatic improvement in the LIBOROIS spread, which we have mentioned previously is a good barometer of the degree of stress in markets.

Chart 1



On the economic front we have seen much "chatter" about the second derivative (the rate of change of the rate of change) of economic growth and similarly many recorded sightings of the "green shoots" of economic recovery. From a statistical point of view the "stabilisation" argument is evident in manufacturing surveys across the world. Similarly we can see from the U.S first quarter GDP report that inventories are likely to contribute to growth in the second and third quarters since they fell at a record, and arguably unsustainable, pace in the first quarter.

Across the world companies engaged in a "frenzy" of production cuts, the likes of which we have not seen since the Great Depression, and in some cases such as Japan, South Korea, Germany and Singapore one could say even more so than the depression. So what began on Wall Street in 2007 moved like a "wrecking ball", in a rolling contagion, through the Main Street of countries all across the globe and even finally touched Sesame Street, with the news that they too had to announce cutbacks.

Throughout 2008 we continued to warn that both economic growth and corporate earnings expectations were way too high and this was painfully illuminated by the "astonishing" bottom up equity forecast, as at September 2008, of a 40% plus forecast for S&P 500 earnings for the fourth quarter of 2008. The record now shows that the outcome was a decline of over 30%. Then as we approached the "lows" in March 2009, some 20 months after the financial crisis had erupted, a number of analysts and economists told us all that the crisis was serious and bottom up equity analysts were "decimating" their earnings forecasts.

If we can now fast forward to May 2009 my big picture observation is that I am less fearful today than I have been in a long time. We appear to have avoided financial and economic Armageddon and markets have moved from pricing a deep depression to pricing a nasty recession.

For the last five months the title of my speeches has been the Mother of all Stimulations and we have written extensively, as have many others, about the unprecedented "quantum" of both monetary and fiscal stimulation and how we await for these measures to gain some "traction". Similarly the world's financial system has in effect been underwritten by the governments of the world and in many ways this has been Lehman Brothers parting gift to the world. Having seen the whites of the eyes of the "financial apocalypse" unleashed by the failure of Lehman, Governments in turn, unleashed the mother of all rescues. I stayed up throughout the night of October 10th 2008 as every worst fear, became reality on my Bloomberg screen and CNBC. So yes I feel a whole lot better in May 2009.

But having said all of this we have not changed the laws of economics and after an era of unprecedented credit expansion we now face a lengthy period of credit contraction (please see earlier Pain Reports for the world's scariest chart, namely debt/GDP in America). This process of balance sheet contraction, or healing, will be driven by further massive deleveraging in the financial sector. The International Monetary Fund's latest Global Financial Stability Report provides a revised estimate of total write-downs in the global financial system to more than U.S\$ 4 trillion. This clearly means that banks will have to continue to raise significant amounts of equity, and similarly engage in a painful and prolonged period of deleveraging.



Credit, as we know, is the oxygen of the global economic system and the simple truth is that we are going to have less of it in the future and hence my very strong belief that we all face a far more frugal future, particularly in the Anglo Saxon world. Whilst on this subject it is necessary to re-affirm my view that house prices here in Australia have further to decline.

In the second quarter of 2008 we forecast a decline of 20-25% in Australian house prices over the next several years and earlier this week we saw the Australian Bureau of Statistics release its first quarter house price index which saw a decline of 2.2% in the quarter, and 6.7% versus a year earlier. This marks the fourth consecutive quarterly decline in house prices. Australia has the most expensive housing in the world when measured by average house prices to incomes and it is this measure that I believe is the single most important determinant of house prices. I am well aware of the supply and demand argument which is being used to defend prevailing house prices, however, it was precisely this argument that people used to validate the bubble in house prices in Japan in 1990 and in the U.K in 2007. Now I am not suggesting for a moment that we have a Japanese style bubble in housing. I am however suggesting that given we have the world's most expensive housing at a time when unemployment is rising, banks are tightening up on their lending standards and household debt is at record levels, that we have a painful "cocktail" of factors pointing inexorably to further declines.

Turning to America we are beginning to see some tentative signs of stabilisation in house prices.

On a nationwide basis they have fallen about 29% from their peak in 2006 and in areas such as California and Florida they have fallen nearly 50%. I would argue that we have a number of years of "housing healing" in front of us, but the big falls are now largely behind us. Yes I know that foreclosures continue to rise, but with new home sales down about 70% from their peak, one has to suggest that we will see some stabilisation from, albeit, incredibly depressed levels. This observation possibly has some relevance at a global macro level and brings us back to a discussion on the "second derivative" argument.

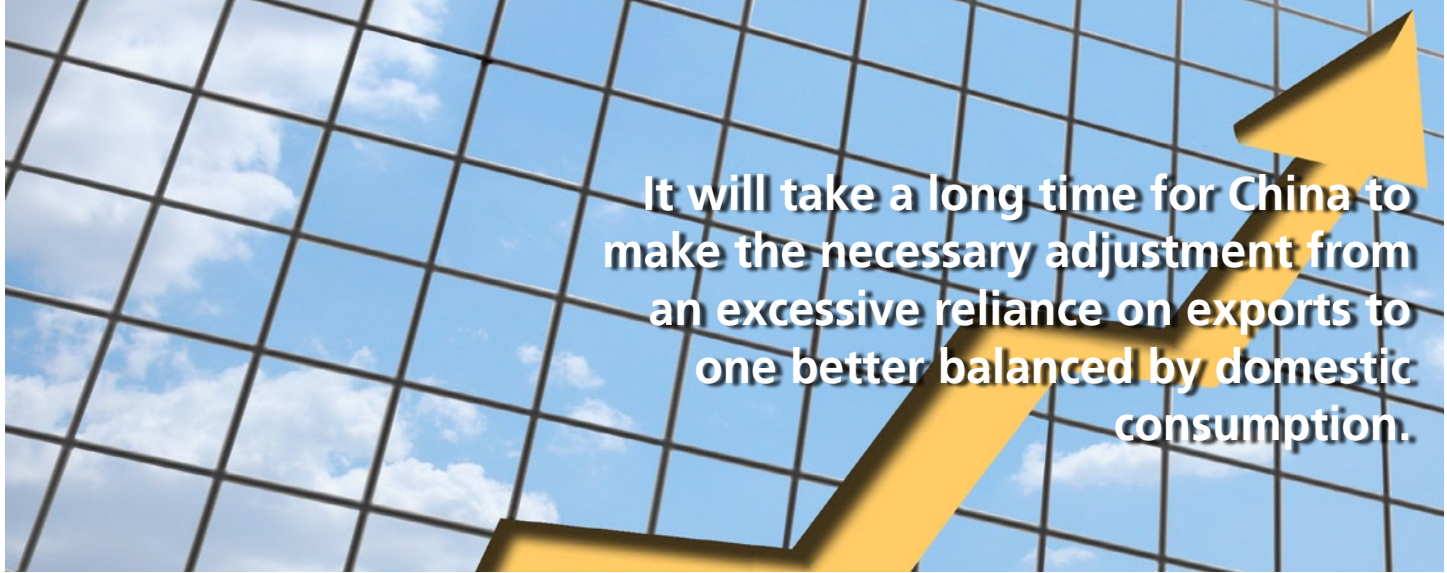
In recent weeks the CEO of Siemens, Peter Loscher, had the following to say, "We see no signs at all of a trend reversal in any of our businesses. There is no solid evidence indicating that the economy might have hit the ground", he then went on further to say, "stabilisation will only set in at a drastically diminished starting level". Powerful stuff and clearly no talk of "second derivatives" or "green shoots" here. Contrast this with recent remarks from Caterpillar who are seeing an improvement in orders from China and perhaps these two very different perspectives tell us a lot about the state of the world.

There is undeniable evidence of an economic rebound in China and the recent manufacturing surveys confirm this and a number of economists are busily upgrading their Chinese growth forecasts. Mine remains at 6% to 7%, but the news flow suggests that a number near 8% is becoming feasible, which quite frankly would be truly remarkable and brings me to quote an old friend of mine, Jim O'Neill Chief Economist at Goldman Sachs, who recently wrote in the Financial Times, "Amusingly, in the past year many people have suggested that the BRIC story is over. Nonsense - it is still in its infancy" Amen, is all I can say to that.

Now many of you will know that I am, and have been, a big believer in India and China so I very much lean more to the IC than the BR in BRIC and it is interesting to note that apparently the number of mobile phones being sold in India has risen to approximately 10 million a month, yes a month!! I think when I first started using this anecdote it was 3 million, then 4 million and last year 7 million. We also know that Chinese car sales, on a monthly basis, have exceeded American car sales for the first time in history. This is perhaps unsustainable over the next year or two, as there are many special factors in the short term, but longer term we know that China is destined to become the largest car market in the world.

Now let's not carried away here as China cannot alone carry the world on its broad, albeit populous shoulders, that would simply be naive. But I find it amusing that all those who dismissed China over the last few years now cite China's pivotal role in the global economy. Now I know that the divide between those who believe in the rise of developing Asia and those who don't is very similar to the divide between bulls and bears and it has indeed almost become religious in its intensity over the last 6 months or so, however I am ever mindful of that wonderful saying "statistics if tortured sufficiently will confess to anything". Everyone is now playing games with statistics and everyone is clutching on to the numbers which best supports their position. I personally am guilty on several counts and alas it is the nature of our "dismal" profession.

In the last several weeks I have become much more balanced in my views and hopefully this came through in my last Pain Report as I did suggest that equity markets were grossly oversold and that the rally had further to run, and that it has. The "perma bears", of which believe it or not I am not, dismiss the rally which I think is simply silly. They could at least acknowledge that the risk of systemic failure has largely been removed. The "perma bulls", well what can one say, for them every day is a new low, as they live in a set and forget world, which can be so very damaging to your financial health. So I am sorry to disappoint you, I belong at present to neither camp and neither should you. Everyone keeps asking was 666 the low? I don't know and I don't care.



It will take a long time for China to make the necessary adjustment from an excessive reliance on exports to one better balanced by domestic consumption.

What I do know is that there is an undeniable improvement in “risk appetite” and there is a mountain of cash sitting on the sidelines and that investors have changed their approach from one of selling on strength to one of buying on weakness. Similarly having been hopelessly in denial in 2007 and 2008 many economists and equity analysts have significantly reduced their expectations of both growth and earnings. Now, if the market is priced for “Armageddon” and it doesn’t happen then one can be forgiven for feeling a sense of relief. That is exactly what has happened, but none of this really helps either you or I. So time for some head on the block views of the future.

As we head for the northern summer many investors are likely to fear being left behind by the current rally in equity markets and this could see the S&P 500 reach for the 1,000 level. As we then move towards the northern winter I feel the markets will experience what best could be described as a reality check as unemployment continues to rise and the consumer continues to reduce spending and increase their savings.

In the second and third quarter economic numbers will be somewhat inflated as companies rebuild their inventories, after decimating them in the past six months. In the meantime unemployment levels will continue to rise and yes we all know that employment is a lagging indicator, but unfortunately the pain in Spain perhaps serves as a warning to us all as they have just seen the jobless rate hit a horrible 17.4%. Countries such as Ireland and the U.K face, in my opinion, a lost decade as they pay for the sins of their profligate past and adapt to a much more frugal future. Countries in Central Europe and Eastern Europe face a particularly bleak future and we have discussed the reasons why in prior Pain Reports.

Financial institutions face further losses on commercial real estate and consumer related debt, credit cards etc and we know that the Western European banks will be particularly hard hit by events in Eastern Europe in addition to problems in their own backyard. Ultimately this current improvement in risk appetite will fade as the prospect of a sustained economic recovery meets with the reality of further massive deleveraging of both financial and household balance sheets.

I continue to favour the currencies of countries that have not engaged in quantitative easing and those that are underwritten by commodities, such as Australia and Canada. I have a bias towards commodities but will not be dogmatic about this view if economic growth looks set to fall significantly in 2010. I urge you all to respect the data and the price action, and take it at face value. Now is not the time for dogmatism, but for an open mind, without preconceived notions and an intellectual approach which is willing to adapt to reality rather than betting the ranch on either black or red.

And yes I continue to be positive on developing Asia, however I will be honest with you all if I see signs that suggest a material change is likely. In brief, China looks likely to achieve strong growth in the second and third quarters, but I have reservations about 2010 as a consequence of the further likely weakening in final demand from the West. It will take a long time for China to make the necessary adjustment from an excessive reliance on exports to one better balanced by domestic consumption. They will achieve this eventually, but in the interim they too will be subject to the increasing frugality of the Western consumer.

Jim O’Neill is right that the BrIC story is still in its infancy and has many decades to run. We in the West are moving inexorably towards an environment of slower growth, but I still very much believe that we can all be one big happy family and yes the world will be a better and more balanced place.

All the best,



Jonathan Pain

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