

Investment Outlook – January 2012

Most economists and strategists do not expect a recession in 2012 anywhere except in the European periphery, as the usual preconditions for a recession simply do not exist. There has not been a multi-year business expansion, there are no inventory excesses, inflation is not rampant and therefore monetary policy is not tight but rather loose. How could an economy weaken under these preconditions?

Don't fight the last war. The risk this time is structural in nature and not the classic inventory adjustment as described so well by Joseph Kitchin in the 1920s. That was a 40-month business cycle that later became interwoven with the 4-year US presidential election cycle. Most of today's economists remind me of my visits to the UK, a country where traffic moves on the left side of the road. As a pedestrian from continental Europe, where traffic moves on the right side, I instinctively look left first because on the continent, that's where the vehicles come from and where I can check my risk as a pedestrian. Not in England, where one should look right to avoid the risk of being run over by a truck. Could it be that most economists look now in the wrong direction to find the answers for the future?

As Reinhart & Rogoff explain well in their book, *This Time Is Different*, once an economy has increased its debt burden above a certain level, it becomes a restraining factor for growth. In combination with high household debt and deflated home prices, the most important collateral in an economy, it is a double whammy to final demand. And that is where we are in the industrialized nations, with only a few exemptions. The chief economist of Nomura in Japan, Richard Koo, has noticed the difference between a "normal recession" (inventory adjustment as described by Kitchin) and what he called a "balance sheet recession" some years ago because Japan has been in it for so long, and he as chief economist of the largest Japanese investment house had to deal with it.

The big difference between a conventional recession, as we have witnessed from the 1950s to the 1990s (1980s in Japan), and a balance sheet recession is that in the latter, a dominating part of the private sector is minimizing debt instead of maximizing profits. Given such circumstances, monetary policy simply stops working as a stimulus for the economy. In contrast, fiscal policy does work, and direct stimulus in the form of government expenditures immediately creates income and jobs that lead to spending. Of course, this is nothing new to those who have always looked far back in economic history and have not just taken the 50 years post-WW II as the model of how economies work. But most investors and experts are still using those formulas that worked well for several decades and during their careers.

As we enter the New Year with those inherited burdens, the question is how the structural restraints will impact the course of economies and financial markets in 2012. Let's have a look at the main regions and potential developments and then combine our thoughts.

Chinese Not-So-Soft Landing

Everyone who has travelled to China regularly over the last 20 years must be highly impressed by what that nation has achieved in such a short time. It is by far the most impressive rise ever of an economy. The economic progress achieved is simply mind-boggling. No wonder everybody traveling to China comes back as an optimist. The Asians still live the values the Western world used to have a few decades ago, although on my recent visit I began to spot some decadence as well. But it may still be early. There is a growing middle class, and they work hard, consume but still save a lot. Their savings often end up in real estate, either as investment or as mortgages. The credit boom in recent years was the biggest credit excess the world economy has ever witnessed. According to the rating agency Fitch, China's debt/GDP ratio has risen a whopping 60% over the last 3 years, to 187% (other sources estimate total debt/GDP at 300%).

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Interestingly, banks have been recapitalized twice in 2011 by the government with an amount of over \$500 billion. These are actually bank bailouts of large proportions. If everything were as strong as the official statistics show, I wonder why the banks needed that much help. Moreover, the sharp rise of the reserve requirements in 2011 that now also affects off-balance-sheet items is a major restraining force. Consequently, the real estate sector is having problems, as it is overbuilt, and the sharp decline in the number of real estate transactions is a forerunner of weaker prices, which in some regions are already visible. The government unofficially said it would like to see prices declining by 20% to reduce the social problems due to mounting prices for real estate and food. While food prices have calmed lately, social unrest has increased in several places. The West's view that the hundreds of millions in poor housing will buy the empty units is a myth, as they simply cannot afford it financially. It reminds me of the story in the US in 2006 that all the Mexican immigrants must buy a new home and all the baby boomer retirees would buy a second home in the sunbelt... Wealth inequality is as big a problem as in the West, if not more so, and the government has to reduce the potential tension by narrowing the gap and bringing those real estate prices down.

The weaker metal prices in the commodity pits speak clearly. The big investment boom is cooling off. While many believe a soft landing will follow, I noticed in my career that fine-tuning large economies rarely ever worked as desired. As export growth is declining sharply from 40% to 20%, below 10% in real terms and could go negative due to the Western world's slowdown and the sharp revaluation of the Renminbi, the surprise this year will be on the downside in China. As other emerging markets and important trading partners of China will also be affected by the slowdown in the West, the inner Asian trade will also suffer. I think the prevailing view that Asia will continue to grow at the high rates of recent years while the West remains sluggish is nothing else but a linear extrapolation of past trends into the future, but it is hardly realistic. While I still see better growth potential in Asia in general in coming years, 2012 could be quite challenging for China and Asia, in my view, and I would be prepared for a not-so-soft landing.

While it is true that the Chinese authorities may begin to relax tight policies, they will only do so slowly. The current government will be replaced in the second half by a new government. And the central bank will prepare the ground for the next administration rather than please the outgoing government in the short-term. Moreover, once an economy begins to slow and authorities begin to loosen their policies, it will take a long time until policy becomes stimulative. It is conceivable that monetary easing alone will not do the trick because a real estate and investment bubble is bursting. Only a new fiscal program could push growth decisively again, and that does not seem likely without a crisis first. That's why I sing a different song than most China experts, who say that the government will manage a soft landing and we should not be concerned. That is too naive a view, in my mind.

Continued US Fiscal Stalemate

The US economy is in low gear due to the restraining structural forces. The deleveraging process continues, and that is the reason why we won't see a normal cyclical growth pattern in 2012. Moreover, we are also witnessing a deviation from the normal presidential election cycle pattern in economic policy setting, with restraint in year 1 and stimulus in years 3 and 4. The public sector debt problem has led to an aberration with a net fiscal drain in 2011 and also in 2012, although at a very high deficit level. No solution to the debt problem is expected this year, as the Republicans certainly don't want to give Obama a chance to look good going into the election in November.

And monetary policy has been so widely criticized that the Fed must be careful not to lose all credibility. Hence, its room for maneuvering has narrowed decisively. I have never in my life seen a serious presidential candidate (Mitt Romney) state ahead of the election that if elected he would not reelect the current head of the Fed. Without QE1 & QE2, the US government would most likely have had the same problem with rising government bond yields and as a result with its banking system as Europe in 2011. But quantitative easing was not responsible for economic growth, as that was solely resulting from fiscal stimulus. For 2012 we can exclude any new fiscal program but will probably see some marginal restraint. Moreover, the US monetary policy is now at a point where it becomes counterproductive, as zero interest rates for long (guaranteed for at least another 2 years by the Fed) and the latest push for lower long-term interest rates leads to an environment that makes many businesses in the financial sector obsolete. Money market funds do not make economic sense anymore and will eventually die. Carry trades that used to lead to at least some credit growth do not make sense any longer due to the flat yield curve. The result will actually be more deleveraging – which is just the opposite of what the central bank wants. In short, it seems monetary policy has arrived at the end of a dead-end street. Whatever follows from here must be direct purchasing of assets by the central bank. To do so requires another crisis first.

With employment hardly growing, real income stagnant and an already low savings rate of 3.5%, I wonder where the growth will come from. Exports helped a bit last year, but with the strengthening US dollar, that is probably also over. At best, I could see about 1% growth in real terms in 2012. This assumes no major problems elsewhere in the world that could affect the US economy.

Europe – Something Has to Give

Europe has come up with one plan after the other to solve its crisis, but nothing really worked. That was to be expected because European politics is trying to square the circle. As I have elaborated many times, the Euro is a misconstruction and will do more harm than good to the European people. We have large differences in competitiveness, and as long as those large gaps are not closed, the imbalances in the balance of payments will continue to grow. This is purely balance-of-payment economics and not any magic forecasting. Within the Eurozone, these imbalances are “balanced” via the TARGET2 program. If an Italian moves his money from an Italian bank in Italy to a German bank in Germany, the flow goes via the Italian central bank to the German Bundesbank. And the result is that Banca d'Italia owes the Eurosystem (ECB) that amount while the Bundesbank gets a claim against the Eurosystem. Most people do not even know that the ECB does not have its own balance sheet, but its balance sheet is simply the aggregate of all the Eurozone's national central banks. This does not seem to be a problem for the ECB. But in this example, Italy and Germany are two sovereign nations, and there is de facto a claim by Germany on Italy but not de jure.

For many years this was never a problem, as money did not flee from one country to another. But from summer 2007 onwards the Bundesbank TARGET2 claims exploded from less than €40 billion to now almost €500 billion. At present, TARGET2 money is by far the biggest asset on the Bundesbank balance sheet. The question is whether the periphery will ever pay it back, or not. If the development will lead to a United States of Europe, it really would not matter, as it would then be within the same country. But if the nations will remain sovereign, it does matter. And should the periphery one day exit the Euro, does one really believe Germany will ever get paid back? Once the German public begins to realize what is going on, it will turn against further help and cooperation. The balance of payment crisis going on in Europe will in all likelihood intensify in 2012, and one can only wonder when anger will break out among central banks, politicians and the public about these claims. The US Federal Reserve Bank has a similar system (FED WIRE), but it balances its accounts once every year with actual payments, and it is all within one country. Neither is the case in Europe.

The hope is that the long-term refinancing operation (LTRO) of €487 billion will solve the banking crisis and help to calm the peripheral government bond market. It is certainly a big help for the banks, as the funding for the 1st quarter is virtually done. The hope of the ECB is that the banks will buy government bonds of the periphery, as the yield spread is attractive. There will perhaps be some purchases, but those banks in trouble because they bought that paper before will hardly do so, and why should those that are sound get in trouble? Actually, about €420 billion of the LTRO money has been deposited again with the ECB, confirming that European banks have little appetite for large purchases of government bonds. The banks need the money to replace the funding from the shrinking money market funds. Moreover, the new BIS regulation forces banks to raise their equity capital, and as I have argued before, most would rather shrink their balance sheet, as they don't want to raise equity capital or simply cannot get the capital. Estimates about the necessary shrinking of balance sheets amount up to €1.5 trillion. In other words, LTRO is a temporary liquidity bridge but does not at all solve the fundamental problem of imbalances due to the misconstructured currency.

Further austerity will sink peripheral economies deeper into recession due to the tough austerity programs they have to execute. It will most likely drag the whole continent into recession for this year – and probably 2013 as well. Greece is already in depression, with GDP down 15% and the stock market trading 90% down from the peak a decade ago. That is getting close to the US depression levels of the 1930s. The periphery has become a prisoner of the Euro, which works like a deflationary straightjacket for them, similar to the gold standard in the 1930s. Those economies in the 1930s that devalued their currency first, came out of the depression first. Germany refused at the time to devalue due to her horrible experience with hyperinflation in the early 1920s. And Germany only devalued once the unemployment rate hit 33%! What followed was the saddest part of European history... I mention this because I expect Greece to eventually exit. Continuing to muddle along as in 2011 is unlikely in my view. Greece has nothing to lose, as the government is bust anyway. Rather default and have an option to recover with a devalued currency than go bust and stay deep down forever without any hope of improvement. Hence, I assume Greece will exit the Euro this year, as the Greek people will force its government to do so.

Ratification of Agreement Will Likely Trigger Turmoil

In early December 2011, the 17 members of the Eurozone agreed to further fiscal integration with strict rules and sanctions. While the exact details are not known yet, the idea is to force all countries into pretty harsh fiscal austerity. If implemented as planned, the whole continent will sink into depression, as rigid fiscal tightening would simply force all economies into a downward spiral. While those 17 governments all agreed to the plan, these agreements have to be ratified by national parliaments or by the people. As that process will get underway, we will see resistance in some countries and some simply will not ratify. As a consequence, markets will then assume that exits from the Euro by some countries will become likely and begin pricing assets accordingly. This ratification process could become THE key issue for financial markets in 2012.

Crisis Intensifies With the First Exit From the Euro

Based on political developments, markets may create their own momentum and thereby force the exit of a country. I am assuming the first country to leave will be Greece. This of course will have serious implications for the global banking system. The exit of one country means that it is bankrupt the next day and with it its whole banking system. The government and many of its private entities will then default. Banks will be nationalized, and after a bank holiday they will reopen, fully financed in their national currency again. No Greek entity will ever pay back its debt to the outside world. And if other countries followed, the outside world would only get a fraction of their claims repaid. In the short-term, it will be another blow to the Greek economy due to complete chaos, but after one year the economy will recover as tourism will begin to flourish due to its regained competitiveness against all other Southern European destinations. Hence, the disadvantage of default may actually be much smaller than the prevailing view. One only has to look at Iceland, where the government and the banks defaulted four years ago, and Iceland now is already back raising money in the capital markets.

The day Greece exits, turmoil in the global financial system will start. As virtually all Greek entities will default, credit default swaps (CDS) will be activated and investors, mainly banks and insurance companies as well as the ECB, will lose a lot of money. Some banks would go down if not bailed out by their own governments. As a consequence, governments will have to go even deeper into debt to save those financial institutions. It will simply be a continuation of the recent crisis but at least one dimension bigger.

It will be obvious that bond yields for other peripheral entities' debt will shoot higher, as investors try to unload the junk. The world will then run for safety. While the liquidity problem of the European credit system has recently been addressed by the LTRO of half a trillion Euros, nothing has been done about the solvency problem of governments and the credit system. With one country exiting, the whole problem will grow much bigger and create chaos in global financial markets. The European OTC fixed-income derivative market is estimated to amount to approximately \$60 trillion notional value. And that is the connection to the US credit system, as US banks are deeply involved.

External Balance Reversion

China's pronounced wage increases and currency revaluations of recent years have now made part of her export industry lose its competitiveness. In combination with the weakening demand from the Western world (which will affect final demand in other emerging economies), I think we are not only seeing the end of the revaluation of the renminbi but also the beginning of the decline of China's currency reserves. This change at the margin has important implications for the funding of other governments, as China used to buy large quantities of government debt in Europe and the US. Moreover, as the upside pressure on the renminbi changes due to capital outflows to some downward pressure, the Chinese central bank will not create liquidity as in previous years but withdraw liquidity at the margin from the system to support the renminbi. Letting the renminbi decline would simply trigger a trade conflict with the Western world. Hence, the whole liquidity creation process we have seen for so many years could be reversing.

In addition, I also expect other major surplus nation's appetite to invest in foreign assets to decline because the risks with investments abroad grow bigger. This will in turn create funding problems for nations with large balance of payment deficits, large government debts and large funding needs. Hence, they will come up with all sorts of gimmicks to assure the funding of their government households. While in countries with currency sovereignty, like the US or the UK, central banks could replace the disappearing foreign central banks, which is not possible in the Eurozone. However, private buyers from other parts of the world could step in when seeking perceived safety. Since the crisis started in 2008, we have already witnessed how governments have changed the rules. Ireland, France, Portugal, Spain and Hungary have already misused the pensions fund system in at least one way if not more to fund their own government. Others like Italy are

now offering more favorable tax treatment to residents buying and holding Italian government bonds. Austria is restricting its banks lending to foreign countries. We will see more steps in this direction by many governments to assure funding. This repressed capitalism will be deflationary in nature in the short run, as it restrains free flow and free allocation of capital. It is clear that countries with large government debt, large public sector deficits and large external account deficits will be the ones suffering first and the most. The problem will grow from the weakest economies towards the center of our system.

The US may be an exemption – at least for a while, as the US trade deficits in view of weaker final demand will shrink. Moreover, the US currency will most likely strengthen as the mounting debt problems in the world will lead to a high demand for US dollars. By far the biggest part of the world's debt outstanding is denominated in US dollars, and as the weakest links in the debt chain are having funding problems (particularly if they are outside the US), they need to buy those dollars in the market. Even as I expect the Fed to print large amounts of new dollars, this will be a drop in the bucket compared with the gigantic debt outstanding and denominated in US dollars globally.

What Does It All Mean For Capital Markets?

While the world may look okay from the bottom up, as many corporations are still doing relatively well, the top-down view with the process at work as described leads to rising macro economic problems that most investors are not prepared for, yet. Whenever a crisis intensifies, prices of risk assets usually decline.

In terms of official **short-term interest rates**, it is absolutely clear that they will remain low, near zero percent for as long as one can see, in all major currencies. Interbank market rates, however, may rise to reflect the malfunctioning market. The gratis funding by central banks is an important element to fund governments, either directly or indirectly, and will stay in place for many years to come.

Long-term government bond yields will behave differently, however. As the deflationary pressure intensifies, the search for safety will also intensify. As long as the US dollar remains firm, there is a chance that bond yields will take another step lower in 2012 to new record lows to conclude the declining trend that started in the early 1980s. That move will be supported by the CPI inflation falling for cyclical reasons, and probably quite sharply so. But the driving force will be the search for safety, not the declining inflation rate.

The same is true for governments with structural external surpluses like Japan, Norway, Sweden and Switzerland. It is even likely for the UK, where monetary policy is trying to offset this deflationary process by buying gilts in large quantities. It would also be the case for Germany, although there are some political question marks. If Germany agrees to some watering down of the agreement and assumes part of other countries debt, Bund yields would not fall to new lows but instead rise again. Hence, Bunds carry a higher risk in the short-term than US Treasuries and offer less potential reward.

This decline in yields during the year will in my view represent the final decline in yields to terminate the more than 30-year decline in bond yields. Hence, those coming lows in yields will be opportunities to sell long bonds and shorten maturities considerably.

One shouldn't try to be very original in terms of **currencies**. In the scenario described, the US dollar will remain strongest until a major policy change toward serious stimulation begins in the world. Stay away from all the currencies of nations with large external deficits, particularly those with recent credit booms and hot money inflow. The Turkish lira is a classic example, or the Hungarian forint, which is already further ahead in its decline.

Don't invest in currencies that are highly dependent on rising natural resource prices, like the Australian dollar or the Brazilian real. The Canadian dollar should weaken against the US unit but still be stronger than European or Asian currencies.

The Singapore dollar is most likely the best currency in the very long-term, but I would wait for purchases until the next phase of weakness in most currencies has run its course and the global policy setting reverses. It will be the prime choice either later this year or in 2013.

The euro should continue to suffer from the unresolved structural issues. Once the weak economies have exited, however, the euro will become a strong and sound currency again, a slightly diluted version of the old Deutsche mark. But this will only be the case once the situation in Europe has been sorted out, not before.

The Swiss National Bank has set an upper limit for the Swiss franc against the euro. I believe they will

defend it, even though they could be forced to introduce some form of capital controls to achieve the goal during the next acute crisis. Hence, the Swiss franc is for the time uninteresting as a currency, as it cannot rise to its full strength. Swiss investors can stay in Swiss francs, however, and use the US dollar for some diversification – for a limited period of time.

Major rebalancing processes always involve large currency movements. This time will not be any different. As the economic situation deteriorates, the political climate will as well. The risk is that nations running into ever deeper problems will eventually introduce capital controls – the structurally sound ones to prevent money inflow from the outside and the structurally weak ones to prevent money flowing away from their system. Hence, a step-by-step increase of capital controls in coming years cannot be excluded. Investors should therefore decide early on in what currency they want and don't want to be on a longer-term basis.

Equities have now underperformed perceived quality bonds since 2000, and in some countries even longer. While equity proponents always said equities outperform bonds in the long term, now the very same experts say equities have underperformed for so long, it is time for a change. And at some point they will even be right – but not yet, in my view.

I expect the world economy to slow more in 2012 than expected by the consensus and corporate profits to disappoint accordingly. Austerity in many parts of the world and the outlook for tax increases for individuals and corporations, as well as more wealth redistribution, will hardly keep corporate profit margins as high as they are, at present. Most importantly, however, will be the pro-cyclical restraining policies in the industrialized countries and to some degree even in the emerging economies. A renewed financial crisis will not only dampen economic growth but also longer-term growth prospects and increase risk aversion once again.

Emerging economies are not immune but are actually levered to the pace of the industrialized world. Moreover, a big part of the market capitalization in the emerging world is hot money from the industrialized world, which may return home when turmoil arrives again. In terms of sectors, the more cyclical the more vulnerable and vice-versa will be true throughout the world. And financials will remain under pressure, as the financial sector balance sheet is fully exposed to the whole debt crisis and governments will corrupt it by misusing it to fund the government. Consumer staples and health care will be the “teddy bear stocks,” meaning investments an investor can sleep well with for a long period.

The US equity market has outperformed in 2011 by a large amount. More than half of the S&P 500 earnings are from overseas, and with the US dollar rising and overseas economies weakening, it will be much more difficult for the US equity market to repeat its absolute performance again. While the US market may hold up longest, it will eventually give in to the bearish cyclical macro factors.

Economic-sensitive **commodities** should decline further in the scenario described, as demand will weaken, and this is particularly true for base metals. The same would be true for crude oil, but there is also a geopolitical dimension to it. The rising instability in the Middle East may restrain the price decline due to economic weakening.

Gold is not immune to increasing deflationary pressure, and the correction that started last summer at \$1,900 will only end once signs of a major economic policy reversal become visible. I had thought a range of \$1,500-1,600 would be a good buy zone, but one cannot exclude temporary dents outside that range. Investors should, however, keep in mind that the monumental debt problems in the world will eventually call for more monetization by central banks and should therefore propel gold to higher highs in future years. In that sense, this current correction may offer another opportunity to increase the gold position in steps.

Keep Defensive Strategy

I find it rather interesting that today's policymakers have discovered the debt problem of the public sector and are trying to apply Hayek's austerity principles of the Austrian economic school of thought to the current situation. That is exactly what the world did from the late 1920s onward, leading to a depression. While the world operated under the gold standard at that time, we are now operating in a fiat currency system that may offset part of the deflationary pressure via temporary waves of monetization. Keynes's theory of government deficits to support the economy in crisis was applied only later to get the world out of the depression. Unfortunately, the world applied Keynes's theories ever since, but in an asymmetric way, as no one was ever interested in balancing the budget any more, not even in good times. Today's zeitgeist will in my view first lead to more austerity, which in turn will trigger another crisis, which in turn will call for more monetization.

Unlike the consensus, I expect another crisis to develop and intensify in 2012. While markets may remain benign in the first few months of the year, I expect import changes to start by late winter/spring. If there is an exit from the Euro, which I expect, the question may then be whether the authorities can quickly control it or whether they lose control and markets cascade lower into 2013. My point is that at the very best, we will see another very painful decline in risk assets in 2012, probably starting in the spring, leading to another great buying opportunity similar to spring 2009. At the worst, developments could get out of control and markets could cascade lower into 2013, offering a great buying opportunity for equities and commodities in 2013. If the latter came true, the decline for risk assets would be much deeper, of course. While we cannot foresee what outcome is more likely, it really doesn't matter for our strategy, as we simply have to patiently wait for the opportunity to arrive.

Investors should therefore stay defensive and preserve capital for the moment when it will be possible to invest at lower prices. Adjust your portfolios during the first quarter accordingly. Once markets hit the lows, risks may be perceived as very high but will actually be low and potential rewards will be much more attractive, of course. Capital can remain invested in US Treasury bonds or other "quality bonds" in the preferred currency. Gold should amount to at least a neutral position and new buying can be done in steps during this year. Stay away from commodities, except perhaps energy as a hedge against geopolitical turmoil. Don't be too creative, and stay away from emerging market currencies, equities and bonds for the time being. Keep it very simple and be patient. The opportunities will eventually present themselves, most likely in the second half of 2012, or in 2013 at the latest. I will try to keep you posted during what promises to become another quite challenging year.

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