



The Pain Report

From the desk of HFA Asset Management's Jonathan Pain

The Mother of all Stimulations

'The greatest threat at present is deflation and hence we are now witness to the "Mother of all stimuli" as policy makers engage in unprecedented monetary and fiscal stimulation.'

First of all, an apology is in order as my last two Pain reports suggested there was a tradeable rally in equity markets. In the Pain report, "Go Fishing", published on October 11 and then in "Yes we can....Buy", published on October 18th we highlighted the view that we could see a significant rally. My line in the sand was the October 10th low on the S&P 500 at 838. We did rally very hard for the next two days, up about 15%, however, on November 19th we crashed through the October 10th low and subsequently fell beneath the October 2002 low. At the time of writing, on November 22nd, the S&P500 closed the week at 800.03.

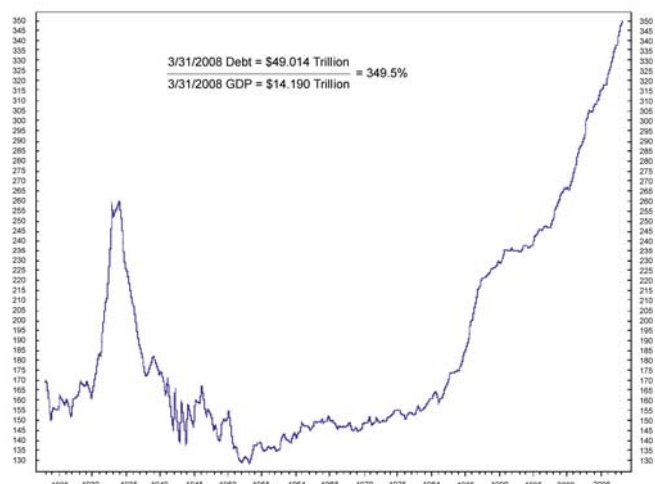
Other equity markets have fared even worse and hence an apology is in order.

History shows us that even the most brutal bear markets have significant rallies, but this one is very special and has already entered the record books as the worst since the 1929-1932 crash.

So perhaps I should get back to basics and do my best to think about the key macro drivers of the global economy and leave the "market timing" to all of you.

As stated in many Pain reports we have entered a period of credit contraction after an era of unprecedented credit expansion. Please see chart one which is one of my "all time scariest charts" and joins Robert Shiller's chart of U.S house prices from 1890 to 2005.

Chart 1- Total U.S Debt as a % of GDP



Source: Ned Davis Research Inc. Quarterly data 31/12/1922 - 31/3/2008

So the age of "No deposit, no worries" is now behind us and hopefully the age of shameful and predatory lending is behind us too.

We now face a more frugal era and this reality is now dawning upon citizens from Washington to Wellington. The adjustment phase is going to be very painful, particularly for those with lots of debt, and whilst we navigate towards this inevitable destination private sector balance sheets will shrink and by default public sector balance sheets will expand. In this regard Governments have much further fiscal work to do and central banks around the world are now in a fascinating race to zero.

The greatest threat at present is deflation and hence we are now witness to the "Mother of all stimuli" as policy makers engage in unprecedented monetary and fiscal stimulation.

As we have been saying for some time now, the whole developed world faces recession and the next few quarters are going to be positively "ghastly".

And yes, even developing countries in Asia are feeling the pain and growth is slowing significantly. At the start of the year we forecast 8% growth in China and the latest data from the third quarter saw growth of 9% and I sense we are likely to see numbers nearer 6- 7% next year. In global terms this will be commendable and there is no doubt that China will continue to be the global growth locomotive in 2009, having been the undisputed leader in 2007 and 2008, with their contribution to the growth in the global economy exceeding that of America.

Alas, in an age of globalisation no nation can be viewed in isolation and even countries such as Vietnam are now suffering the consequences of the born-in-the-USA virus.

I travelled to India and Hong Kong in late October and there was overwhelming anecdotal evidence that the stock market crash of October 2008 had indeed had a massive impact upon consumer and business confidence. The Wall Street crisis had finally arrived in Main Street Asia.



No one, and I mean no one, has ever seen anything like this before.

In earlier Pain reports we discussed the nasty reality of “negative feedback loops” and how the credit multiplier was now working in reverse. Now the global consumer has just entered a lengthy hibernation and this coupled with banks cutting back on lending and companies reducing staff will simply further exaggerate and amplify the economic downturn. In such an environment governments and central banks need to take up the slack and expand their balance sheets as the private sector shrinks their own. We are all Keynesians now and hopefully every policy maker is up to speed with what needs to be done.

In 1911 Irving Fisher formulated the quantity theory of money and it is, in essence, a simple “identity” where $MV = PT$. M is the quantity of money, V is the velocity or turnover rate of money, P is the price level and T the volume of transactions.

Given that we are witnessing an unprecedented injection of liquidity (money) into the financial system why are neither P or T rising? Look no further than U.S Treasury bills which this week reached a level of one basis point, I repeat one basis point, and in fact Treasury bond yields across the “curve” reached historic lows. The fact is that investors are more concerned with the return of capital rather than the return on capital and have hence sought safe haven in Government securities and as a consequence the velocity of money has collapsed. There are very few episodes in history when this has occurred. The most recent being Japan and they of course experienced a full blown Keynesian “liquidity trap”. Until such time as the velocity of money recovers we shall not see traction between money supply and either P or T.

In this fundamental regard Governments must come to the rescue and restore V through massive fiscal spending and restore some semblance of “animal spirits” to the global economy.

In addition, central banks must do their part too and drop interest rates as quickly as possible and as far as possible. The risks are entirely “assymetric” in nature as the risk of deflation at a time of record debt is fatal, whilst inflation eases the pain of debt and can be cured in time. It is important to once again stress that we are seeing an unprecedented period of asset deflation with house prices, stock prices and commodity price declines now amounting, according to some estimates, to an astonishing 30 trillion U.S dollars.

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Now, regarding some of the rays of light in this remarkably dark tunnel is that we appear to have avoided a “systemic” banking collapse and similarly, due to the unprecedented nature of the crisis, we clearly have unprecedented monetary and fiscal measures being adopted by every country in the world. And yes, in time these will work and as we discussed earlier, once the velocity of money increases we shall see monetary policy gain some traction.

In the interim, more banks will be nationalised and at the close today there was “chatter” in the markets that Citigroup will be taken over by the government having seen a 61% decline in their share price in just the last week. It is interesting to note that they have assets of approximately U.S \$2 trillion which is larger than the whole hedge fund industry. Citi is definitely in the too big to fail category and the American authorities will not allow another Lehman event to happen.

Sorry, I was meant to be talking about rays of light, but in reality the very fact that governments now understand the nature of the crisis, having been in denial for so long, at least now we should be able to say that “systemic” risk has been removed. In addition, as I mentioned previously, house prices in some regions in America, such as Florida and California have fallen nearly 50% and hence we are close to the bottom and on a nationwide basis we might be only 10 % away from some kind of stabilisation.

In countries like Britain there is much more housing pain to come and here in Australia we are seeing widespread evidence of sharp declines in prices and my forecast of a decline of 25%, made at the beginning of the year, will prove to be very conservative.

Corporate earnings forecasts still need to come down, but at least with stock prices now down 50% the market is better pricing economic reality.

In the months ahead we shall see further cuts in interest rates and may I make a special plea to the Reserve Bank of Australia to get rates to 3% as quickly as possible, this means a minimum of a 1% cut in early December and then another 1% in early 2009. Then again, if we know rates need to be at 3%, and soon, why doesn't the RBA simply take us there immediately. Some suggest this will lead to a collapse in the currency, but in reality a dramatic cut could boost consumer and business confidence and therefore serve to support the currency.

Similarly, I believe one of the reasons (obviously the worsening expectations in global growth and the commensurate collapse in commodity prices was the primary reason)why the A\$ fell so sharply is that the Glenn Stevens “Alice in Wonderland” approach to monetary policy earlier this year, fully supported by the chief economists of the major banks here even up until July THIS YEAR, that we needed HIGHER rates, led to massive selling by foreign investors who could not comprehend the “head in the sand” policy stance. Maintaining interest rates at 7.25% in the face of the mother of all credit contractions - which began in June 2007 - all the way until early September 2008 can now be seen as a grave error in judgement. The RBA now has a chance to make amends.

So we are now witness to the Mother of all Stimuli and at some point in time, possibly the second half of 2009, we shall see some recovery in the global economy, led by Asia.

I obviously don't know how low we can go in terms of stock markets.

I do know that this is not the time for a set and forget approach to managing money and this is definitely the time for an active absolute approach.

If your fund manager is chained to a fully invested equity benchmark and their stock selection is largely pre-determined by the relative weightings in that benchmark then you will be pretty much fully invested through every gut wrenching gyration and more often than not own stocks that even the fund manager, responsible for your money, would not personally own. Does that make sense?

This is not a sensible way to manage money.

In the years ahead we shall finally see the great portfolio debate resolved and there will be active and passive managers. There is absolutely no conceptual case for an approach that is neither active nor passive and that masquerades as active whilst hugging an index and hiding behind tracking error as a measure of portfolio risk.

Not all absolute return funds are good, not all absolute return funds are bad, it is simply a way of managing money, and certainly is not an asset class.

Some research houses understand this, some don't, and the media is largely silent on this important debate.

For some curious reason the absolute return approach is classified as "alternative" and the relative return approach is called "mainstream".

Moving forward can we please use the terms active and passive and then finally we can make some headway and illuminate the reality that a fund that derives approximately 95% of its performance from the market can surely not be described as active.

In closing, it's been a really shocking year and the contrarian in me, as the markets plummet and valuations improve, makes me feel more positive as markets now fully price a very severe recession. There is no doubt that the macro economic data is going to be absolutely ghastly over the next six months, but equity markets are down 50% plus and government bonds are insanely expensive and arguably now price outright depression.

In fact, the TIPS (Treasury Inflation Protected Securities) market is now pricing outright deflation in America over the next five years, with the 10-year TIPS pricing nearly zero inflation. Given the unprecedented degree of monetary stimulation, I would not put money on inflation being zero over the next 10 years. I agree we are in for a sharp decline in inflation over the next few years, but that is already in the price. Similarly I would argue that in some parts of the credit markets that we are now pricing in outright depression with the implied default rate on high-yield bonds now higher than the actual defaults during the Great Depression.

Similarly, the CMBS (Commercial Mortgage Backed Securities) market is now trading at ridiculously cheap levels which led one analyst to recently remark: "The default levels implied by where these bonds are trading mean we will all be living in boxes".

I know things are really bad and they are going to be really horrible for some time and I know that the Anglo Saxon world has to adjust to a new world of spending less and saving more and perhaps I am becoming more bullish because I am just plain bored of being so depressing and bearish.

But I do think that there is hope on the horizon and yes, I do believe that Obama is part of a new beginning and you can call me naive if you wish.

Whilst I was in India last month, I was overwhelmed by not just the sheer mass of humanity and the terrible poverty but also very conscious of the extraordinary desire of India and every Indian to continue its remarkable rise.

The obstacles are enormous and with more than half the nation living on less than \$2 a day, they have a real challenge on their hands. Infrastructure is shocking, bureaucracy is suffocating and pollution is dreadful BUT, bit by bit, they are moving ahead and in a decade from now and in the decades ahead they will be a major economic power and incomes will rise, spending will increase and heaven forbid there are many more cars on the road.

This year and into next India will suffer, in economic terms, but it remains an extraordinary possibility full of remarkable opportunity.

You see this desire to move forward all across the developing nations in Asia and we must understand that over 3 billion Asians have embarked upon the path of economic development and the centre of economic gravity continues to shift inexorably towards them.

I know I have frightened many of you with my views on America over the last several years, but it is an economic basket case and it is now plain to all that it is one big debt bubble that has just burst, but at least now we all know it we can do something about it.

The world has just changed very dramatically and I know I have said this before but I think the world will be a better place in the years to come.

This may be my last Pain report for 2008 and, if it is (which I hope it is!!), then I would like to wish you all a very happy New Year and it has been a pleasure, once again, to have had the opportunity of speaking to many of you through the course of the year.

All the best,



Jonathan Pain

P.S. It has been nice to know that the Pain report is now read across a range of different countries and I enjoy the feedback, and I wanted to make special mention of my friends in Dubai who regularly comment on the report and I hope to see them soon.

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