



15th June 2009

Of inhuman bondage

“Bush behaved incredibly irresponsibly for eight years. On the one hand, it might seem unfair for people to blame Obama for not fixing it. On the other hand, he’s not fixing it. And not fixing it is, in a sense, making it worse.”

- Alan Auerbach, economist at the University of California in Berkeley.

It’s the bond market, stupid. Equity markets may or may not have turned a corner from their recent lows (the signs are improving even if the global economy is not), but government bond markets increasingly look like a grisly road accident in progress. Which is as it should be. 10 year Gilt yields have risen by a third, from 3% to 4%. 10 year US Treasury yields have doubled, from just over 2% to 4% since December. Not even President Obama can oversee a \$1.2 trillion annual **deficit** during years (2009-2012) that were previously forecast to be showing a **surplus** (of more than \$800 billion a year) without Treasury bond investors getting spooked. And it’s bad luck when you’re dependent on the likes of China (foreign exchange reserves: c. \$2 trillion) and Russia (over \$400 billion) to fund your grotesque efforts to support Wall Street bonuses and the housing market. It’s almost as if George W Bush departed from Washington determined to make the Oval Office uninhabitable for his successor. Having said that, Gordon Brown seems to be going through a similar ‘scorched earth’ policy for the UK’s public finances – and we don’t even **have** a Wall Street.

David Leonhardt (“[America’s sea of red ink was years in the making](#)”) suggests two basic truths about America’s colossal federal deficits:

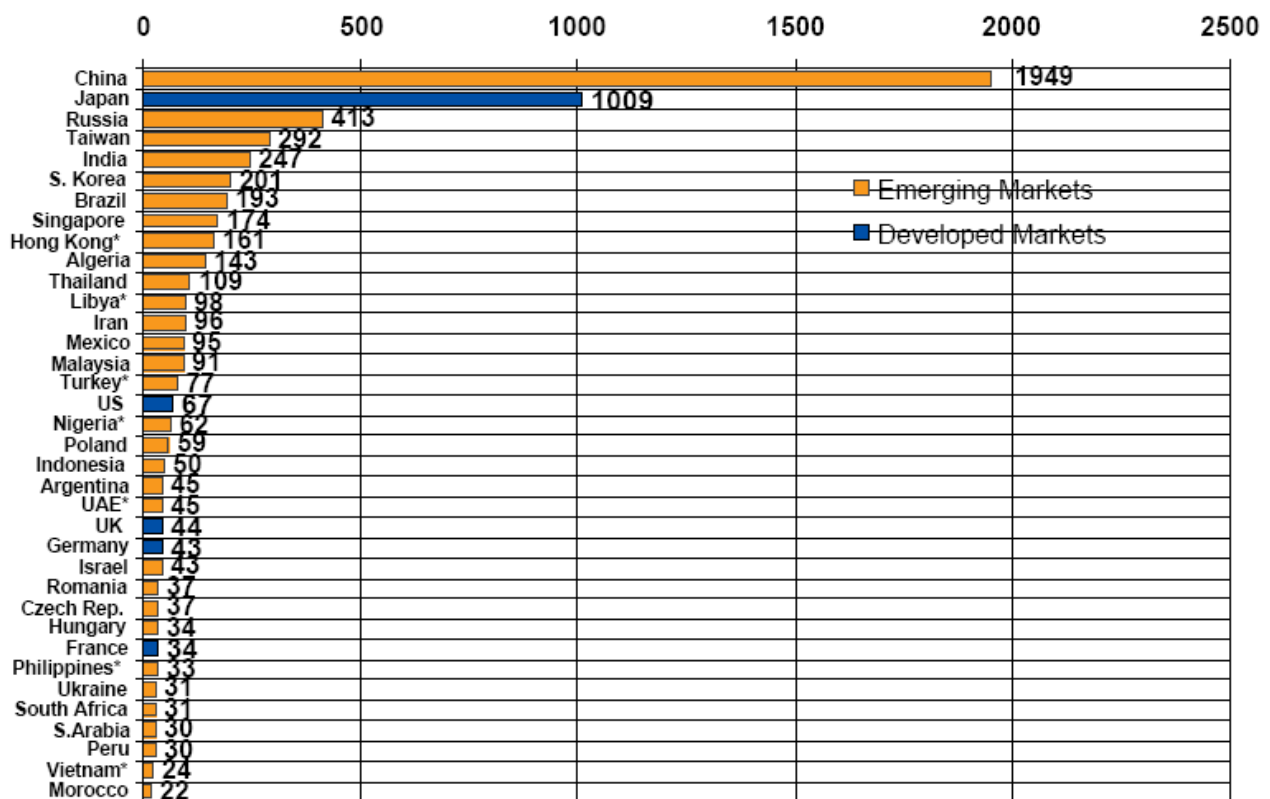
“The first is that President Obama’s agenda, ambitious as it may be, is responsible for only a sliver of the deficits, despite what many of his Republican critics are saying. The second is that Mr. Obama does not have a realistic plan for eliminating the deficit, despite what his advisers have suggested.”

At least America has an engaged commander-in-chief. The UK has a tired, unpopular, half-blind Scotsman wholly diverted by the implosion of, and infighting within, his tired and unpopular party. In any event, the time for action on government deficits is **before** the market senses you may have to restructure your debts. But the latest unedifying spectacle from Westminster, the capital city of unedifying spectacle, last week saw a rather artificial row develop between Labour and the Conservatives over public spending cuts. Get real. There is no real debate to be had over public spending cuts except how much, and when. Since the only jobs that Labour has created during its term of maladministration have been in the public sector, it is hardly in a position to seize the fiscal moral high ground now.

So the great asset class pendulum has swung. Notwithstanding a terrible bear market and a global recession, **equities still have appeal**: the potential for growth in real terms. G7 government bonds have none, unless you believe we are really headed for a deflationary depression – and the experience of history, fiat money and inflationist government policy strongly suggests otherwise. And the ‘free lunch’ of banking sector bailouts has now been, somewhat belatedly, revealed as **anything but**. Taxpayers are and will be footing the bill for the foreseeable future. Amusing to see just how unrepentant the bankers are.

The swinging of a great pendulum has not just been in asset classes (with momentum and relative attraction shifting from bonds to stocks), it has also been in geographies. Last year, for the first time ever, the developing world consumed more energy than the developed. And this year, the US, Canada and Europe will generate less than half of global economic output, according to the Centre for Economics and Business Research. The emerging markets have come of age. We now need some new tag to describe an admittedly vast region that in many respects has better fundamentals than the West: better growth prospects; larger foreign reserves; less sovereign indebtedness; better GDP per capita growth; a stabler banking system; superior household finances and savings rates. **Resurging** markets, perhaps ?

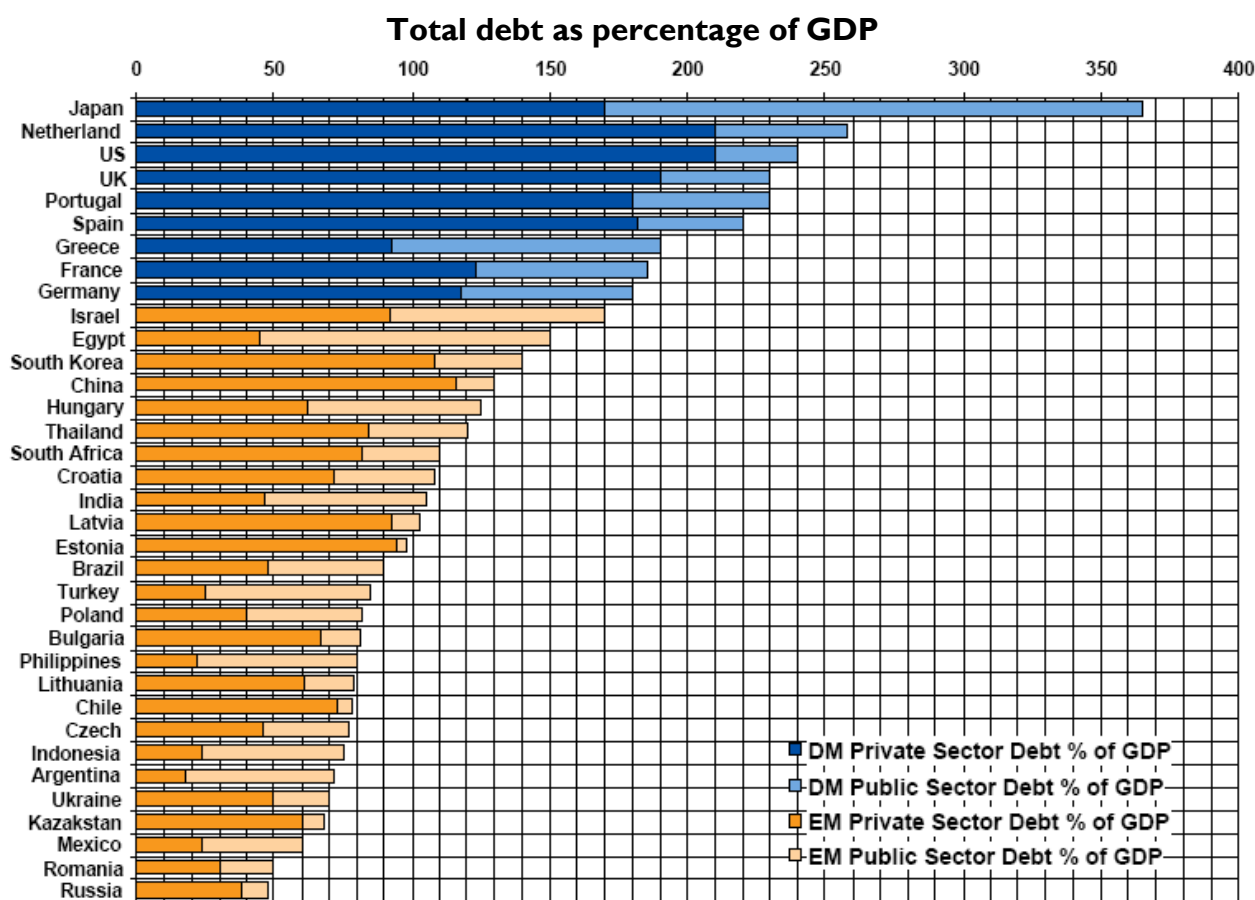
Where the money is: emerging vs developed markets, foreign reserves, US \$ bn



Source: EIU; IMF. Data as at September 2008. Courtesy of Franklin Templeton Investments.

The chart above certainly tells a story. Japan apart, the first developed nation with meaningful foreign exchange reserves is the US, sandwiched between Turkey and Nigeria, at Number 17 on the list. Apologists for the US will no doubt point out that with the US dollar as reserve currency, the US has no need of foreign reserves. But that is to validate future policy by way of the rear view mirror. While it may take some time to replace the dollar as global reserve currency, its relative decline versus resurgent (not least Asian) currencies looks unstoppable for as long as US politicians are unable or unwilling to bite the bullet of fiscal responsibility rather than reckless

denial. The flip side of this chart is total sovereign debt as a percentage of GDP, which unsurprisingly has western nations taking pride of place, as the chart below makes clear:



Source: IMF, CIA World Factbook, Eurostat, ING. Data as at December 2007. Shows total debt in the economy, both public and private. Courtesy of Franklin Templeton Investments.

Having rallied fairly convincingly off their recent lows, stock markets now seem to be caught in a summer torpor, grinding sideways ahead of a further breakout. The direction of stock markets, however, is for us an irrelevance: what matters is identifying quality stocks with sound fundamentals and fair valuations for businesses that can be expected to weather the recession better than most. Defensive stocks have hugely lagged this rally, but that is no reason to ignore them. And for investors with the risk appetite to suit, mid cap value stocks – again, with sufficient cushion against recession by way of balance sheet strength – offer compelling growth potential. But the real elephant in the room, as the charts above clearly identify, is the vast potential of Asia. We remain convinced that the most attractive sector of the global debt markets is that relating to the most creditworthy sovereign issuers – countries and corporates within them that are inherently solvent rather than bankrupt. In equity market terms, Jeremy Grantham rightly points out that ‘growth’ countries do not necessarily correlate to the best equity performance. But during this ‘changing of the guard’, investors will be hard-pressed to find fundamental reasons to buy knackered, ex-growth, largely insolvent economies such as western Europe’s, when they can buy healthy, pro-growth solvent economies in the so-called ‘developing’ world. Whether in equity or bond market terms Jim Morrison had it wrong: it is surely not the West but the East that is best. Driver, where are you taking us ?

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