

VOLUME 10
ISSUE 9
MAY 30, 2008

INSIDE

Listening In
Pair Sees Challenges
Galore, Valuations
Hideously Dear

PAGE 1

Guest Perspectives

BOB MCCURTAIN
*Housing Long Way
From Bottoming*

MIKE MASTERS
*Institutional \$\$\$
Swamps Futures*

GAVEKAL
*Bolstering Master's
Commodities Thesis*

ANATOLE KALETSKY
*Credit Crunch &
Materials Prices*

ABE BRILLOFF
Accountability Cure

GEORGE FRIEDMAN
Oil Regime Change

Chart Sightings
ABDALLAH & GAVE
Oil Contango

MARK LAPOLLA
Driving NDX & Oil

GAIL DUDACK
1973 Redux?

News Bites
Acute Observations
Comic Skews

ALL ON WEBSITE

listeningin

Inflation Not The Problem

But Market Fundamentals "Appalling," Edwards & Montier Say

*In the cacophony that is global investment strategy research, **Albert Edwards** (that's him, below left) and **James Montier** (on the right) stand out as clearly distinctive voices. And not merely because of their British accents or because they've tended to the decidedly bearish side of the scale over the last decade or so. Despite long tenure in the rarified top echelons of the investment banking world, for many years with **Dresdner Kleinwort** and more recently at **Societe Generale** (where they are co-heads of global cross asset strategy) both have managed to retain a natural plain-spoken bluntness. Also large dollops of common sense and strong streaks of reflexive independence, which they employ in conveying their often invaluable insights on investment strategy. In Albert's case, those spring mostly from his long experience in the dismal science of*

economics and in James', from his

explorations of the equally mysterious realms of behavioral neuroscience.

They are, in a word, skeptics, and at this juncture most deeply skeptical of any and all notions that "the worst is over." The recession, which has barely begun, is more likely to be deep than shallow, market valuations are hideously expensive and the -flation policymakers should be worried about starts with de-, not in-. For their reasons, keep reading, if you dare.

KMW

You two made a big move not long ago—

James: Uncharacteristically.

Albert: Yes. I was with Dresdner Kleinwort for 19 years.

That qualifies as an eternity —

Albert: Yes. In this business, it's pretty



Kathryn M. Welling
Editor and Publisher
welling@weedenco.com

*Published exclusively
for clients of
Weeden & Co. LP*

Lance Lonergan
National Sales Manager
(800) 843-9333 or
(203) 861-7670
lance@weedenco.com

Thomas Orr
Director of Research
(800) 843-9333
tom_orr@weedenco.com

Noreen Cadigan
Director of Research Sales
(203) 861-7644
ncadigan@weedenco.com

Jean M. Galvin
Business Manager/Webmaster
(203) 861-9814
jean_galvin@weedenco.com

Karin-Marie Fitzpatrick
Editorial Assistant
fitz@weedenco.com

Subscriptions:
Pat Quill
(203) 861-9317
pquill@weedenco.com
Deirdre Sheehan
(203) 861-7636
dsheehan@weedenco.com

Published biweekly
on Friday mornings,
by **welling@weeden**,
a research division of
Weeden & Co. LP.
145 Mason Street
Greenwich, CT 06830.
Telephone: (203) 861-9814
Fax: (203) 618-1752

Copyright Warning and Notice: It is a violation of federal copyright law to reproduce all or part of this publication or its contents by any means. The Copyright Act imposes liability of up to \$150,000 per issue for such infringement. **welling@weeden** does not license or authorize redistribution in any form by clients or anyone else. However, clients may print one personal copy and limited reprint/republishing permission may be made available upon specific request. Copyright 2008, K.M. Welling. All rights reserved.

amazing. But James and **Andrew Laphorne** decided to move and once they said they were going – since they had the power switch to my computer – I thought I’d better move with them. Otherwise, I wouldn’t be able to get onto my computer anymore.

James: He’s not kidding. That’s the scary thing.

Albert: Yes, I’d be lost without them so I thought I better come with them.

Glad you did. You fellows put out some wonderful – distinctively different research.

Albert: Well, thanks very much. We don’t often see what others are writing. But we imagine it’s much the same–

James: Or maybe not: “Not to worry, everything’s all right!”

Albert: It’s funny, I actually did read something **George Magnus**

[senior economic adviser at UBS Investment Bank] wrote in the *FT* a few days ago [May 20], and thought, my God, it’s virtually the same sort of thoughts I was expressing on inflation in my last weekly: “Fears of a wage/price spiral overblown. Slackening Labor market holds the key.” So, I thought, maybe I’m not as mad as I was thinking I was. Then again, he’s out on a limb, as well.

It’s definitely not consensus now to suggest inflation isn’t a major threat. **Albert:** Yes, but the basic message isn’t all that remarkable – as long as unit labor costs pressures are next to nothing, you’re not really going to get a pick-up in inflation. No matter how much people worry about it. Anyway, maybe I’m outside the mainstream!

I actually have a mental image of James patrolling your offices with a cattle prod – and using it to break up any “herding” activity he observes.

Albert: Yes, exactly. That’s why I had to get away from the office. I’m taking a short holiday, sitting out on my balcony on the French

Med with a glass of wine – I bought a *five-liter box* for 8 euros.

And James thinks *he’s* the value investor!

James: Price isn’t the sole determinant of value!

And here I thought wine-in-a-box sales were more or less limited to American college campuses.

Albert: These wine boxes go for next to nothing down here. You also can get loads of bottles of wine for about 3 euros. Life is very tough here. I’m just going to light up a very nice *Cohiba* here while we chat.

James: You’re really just rubbing it in.

“The underlying fundamentals are appalling. Economic growth is crumbling and the market is still hideously expensive... people tend to forget that valuation is a binding constraint, albeit only long-term.”

Where are you taking your holiday, exactly?

Out on France’s Spanish border, near Barcelona. I am getting married in October and my fiancé bought this quite small place in the last town on the coast, just before Spain. Everything is very chilled out down here. This is the cheap part of the south of France. It’s not like in Nice or Monaco. It’s the least-expensive part of the French Med.

But it’s still the French Med.

Albert: Yes, and James and I recently held an

off-site here.

James: A rough assignment.

Not at all, it would seem. Yet you both came back reasserting your bear cases –

James: That’s what happens when we spend too long together –

Albert: Exactly.

James: Reflecting an occupational hazard – confirmation bias.

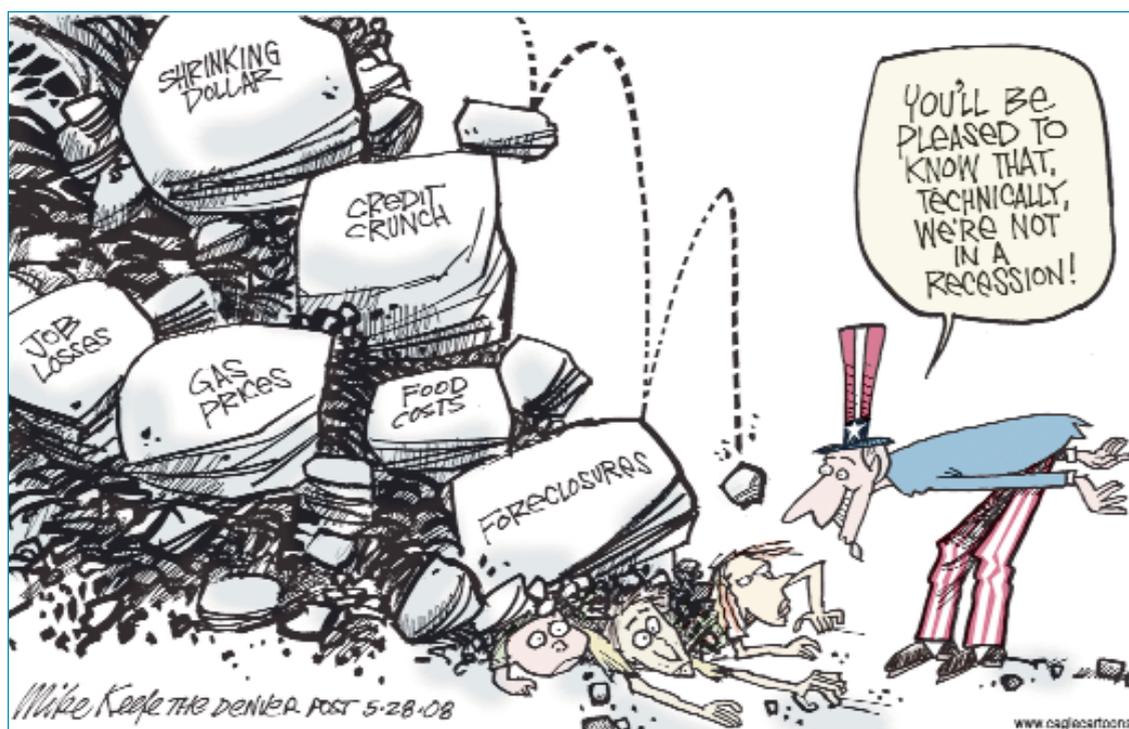
Just how uncomfortable did things get for you two “permabears” during the spring rally? I know Albert actually did call for a bit of an upswing in January and even increased your recommended equity exposure a little, but no one would mistake either of you for Pollyanna.

Albert: James, you go on, while I have a few puffs here.

James: Of course, Bertie undid all of his temporary optimism by taking his recommended equity exposure down to the minimum possible, 30%, on May 8 – which actually is lower than he'd gone in over a decade. Nothing has gotten uncomfortable yet, though it's never fun when the market moves against you. We've been increasingly scratching our heads, thinking, "I just don't understand what's going on." When you get the financials issuing tremendous amounts of fresh equity; when all the financials are having rights offerings or doing other things to raise capital, to me, this is dilution, is it not? So it's madness, utter madness, when existing shareholders are not only *not* worried about this, they're actually cheering it. The **Royal Bank of Scotland Group Plc** (RBS LN) has the largest rights issue in European history, and everybody cheers it! It makes no sense. As I wrote, it's the financial equivalent of being mugged and turning around and saying, "Thank you. But should we head off to the cash point so I can give you some more?" I just can't get my head around why people are doing this. The only thing I can come down to is that it's sort of a conspiracy of optimism. We know that in our industry it generally suits people if markets go up, and so I think that's what people are hoping and praying happens. But all the evidence points, in my mind, to this being just the very first wave of a crisis. That's why I put that chart and quotes [see pages 4 & 5] from **Colin Seymour's** webpage (which **Marc Faber** had alerted me to) in a recent weekly report, showing all of the optimism about the market all the way down after the Crash in 1929. It's kind of the same thing now. You get all these chief execs from financial institutions coming out saying, "Oh, well the worst is behind us." And I'm thinking, "*Right*, because *you* really saw it coming!"

You can't blame them for hoping, especially the ones still trying to keep their jobs.

James: Exactly. They're talking their book. If



you were a short-seller and you tried to do that, you'd be hauled up in front of the court, but these guys are somehow immune from that kind of pressure. They're allowed to get away with these ridiculous statements. The bottom line is I don't buy the whole "the worst is behind us" thing. Economic reality, which is definitely more Albert's bailiwick than mine, says that the recession has barely begun, and yet everybody's pretending it's over. What we've seen is just the first wave of the market crisis hit; we've very probably got an economic recession that will undermine people's confidence yet again still to come.

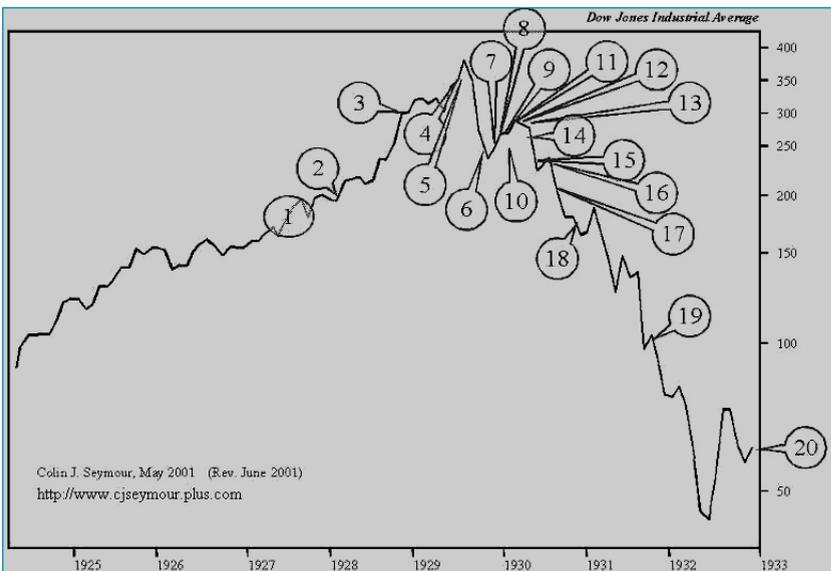
Any scrap of data that can possibly be construed as positive is greeted by the market as confirmation that salvation is at hand. It clearly wants to believe.

Albert: Yes, but I've got an even simpler explanation for this, maybe, than James' conspiracy of optimism. It's just that when a market falls 20% or 30%, you *do* get bear market rallies. You get a rebound. I mean, that's what I saw in January. Even I, who am hopeless at tactical allocation, could see the technicals lining up. The AAI survey, the put/call ratios, the market relative to its moving average – just about every technical indicator you could think – of was lining up, calling for a technical bounce. After all, in the bear market of 2000 to 2003, you had three or four rallies of about 20-odd percent on the way down, before the bottom was actually hit. These sorts of rallies maybe carry on for a

To subscribe to **Welling@Weeden** or hear about the other research products Weeden offers, please contact:

Pat Quill
(203) 861-9317
pquill@weedenco.com

Deirdre Sheehan
(203) 861-7636
dsheehan@weedenco.com



1. "We will not have any more crashes in our time." - John Maynard Keynes in 1927 [NB: The authenticity of this one is a little suspect.]
2. "I cannot help but raise a dissenting voice to statements that we are living in a fool's paradise, and that prosperity in this country must necessarily diminish and recede in the near future." - E. H. H. Simmons, President, New York Stock Exchange, January 12, 1928
"There will be no interruption of our permanent prosperity." - Myron E. Forbes, President, Pierce Arrow Motor Car Co., January 12, 1928
3. "No Congress of the United States ever assembled, on surveying the state of the Union, has met with a more pleasing prospect than that which appears at the present time. In the domestic field there is tranquility and contentment...and the highest record of years of prosperity. In the foreign field there is peace, the goodwill which comes from mutual understanding." - Calvin Coolidge December 4, 1928
"When the financial and business history of 1929 is finally written, developments of the past fortnight will occupy a prominent place in what will doubtless be the chronicle of an exceptionally brilliant twelve month period." - The New York Times, July 1929
"It becomes increasingly evident that, in many respects, 1929 will be written into the commercial history of the country as the most remarkable year since the World War in point of sustained demand for goods and services." - The New York Times, August 1929:
4. "There may be a recession in stock prices, but not anything in the nature of a crash." - Irving Fisher, leading U.S. economist, New York Times, Sept. 5, 1929
"Stock prices will stay at high levels for years to come, says Ohio economist" - The New York Times, II, Page 7, Col. 2, Oct 13, 1929
5. "Stock prices have reached what looks like a permanently high plateau. I do not feel there will be soon if ever a 50 or 60 point break from present levels, such as (bears) have predicted. I expect to see the stock market a good deal higher than it is today within a few months." - Irving Fisher, Ph.D. in economics, Oct. 17, 1929 **The market went into decline until Monday, October 21st, 1929**
"He dismissed yesterday's break in the market as a 'shaking out of the lunatic fringe that attempts to speculate on margin.'" - Irving Fisher, The New York Times, Oct. 22, 1929
"Security values in most instances were not inflated."
"The nation is marching along a permanently high plateau of prosperity."
"Any fears that the price level of stocks might go down to where it was in 1923 or earlier are not justified by present economic conditions." - Irving Fisher, speech to a banking group, Oct. 23, 1929
"This crash is not going to have much effect on business." - Arthur Reynolds, Chairman of Continental Illinois Bank of Chicago, October 24, 1929
Flashback to "Black Thursday," Oct. 24, 1929: Stocks opened moderately steady in price, but traders whose margins were exhausted began selling heavily... at one o'clock the stock ticker was recording prices from half past eleven... stocks dropped 11% intra-day... After a bankers' consortium sent NYSE Vice President Richard Whitney to the stock exchange floor to offer to purchase in the neighborhood of twenty or thirty million dollars' worth of stock at the previous selling price [most likely above their quotations], the market eventually closed with only a 2% loss. [Ref: Only Yesterday: An Informal History of the 1920's, Frederick Lewis Allen, Chap. XIII.]
Not long after, the stock market plummeted in two days of panic: October 28 became known as "Black Monday" (13.47% decline in the Dow), and October 29 as "Black Tuesday" (11.73% decline in the Dow). Between October 23rd and November 13th, 1929, the Dow fell by 39%.
"There will be no repetition of the break of yesterday... I have no fear of another comparable decline." - Arthur W. Loasby (President of the Equitable Trust Company), quoted in NYT, Friday, October 25, 1929
"We feel that fundamentally Wall Street is sound, and that for people who can afford to pay for them outright, good stocks are cheap at these prices." - Goodbody and Company market-letter quoted in NYT, Friday, October 25, 1929

few months, until things get rich enough again. While the market's rallying, people do have to fill column inches and people *feel* things are improving because the markets are rallying. But all that's happened is technicals correcting. So I – and a few other commentators who are much better at this sort of technical stuff than I – have all drawn a line under this rally in the last week or so and said, "That's just about it." Even I can see that the AAII survey, for instance, has gone back up to extreme levels of bullishness. So have put/call ratios. The puts have come way down relative to the calls again. So actually we've just had a technical bounce, and it hasn't been *particularly* strong. You basically clawed back about half of the losses you'd made from the peak and now we're on our way down again. So lo and behold, people will start writing it up as if the world's about to end again. How would you describe that, James? It's understandable. We have this saying in behavioral investing terms that you can actually semi-rationalize the irrationality of it.

James: Yes. It's typical *ex post* justification. There's this wonderful experiment in psychology with people queuing for a photocopier. In one version people are butting into the queue saying, "Excuse me, I need to make copies," while in the other, they just say, "Can I butt in?" Well, as soon as they say, "Because I need to make copies," people begin to think it's perfectly reasonable for them to jump into the photocopier queue. But it's what we call placebo information; it's just noise. The reality is that there is a tremendous amount of noise in the markets, and I think it tells the real investors from a lot of the others. They have the ability to screen that noise out and look for the signal, while those who confuse the noise and the signal end up overreacting to what is effectively just random price movement.

Albert: There's certainly a lot of noise. I mean, when we went into our lowest-ever equities weighting on May 8, it was to send as strong a signal as possible that we're actually drawing to the end of this rally.

You wanted to make it perfectly clear that you are even more bearish than you were before your timely January "thaw."

Albert: Yes. It wasn't difficult to call that rally, and take our equity exposure up to 45%, from 35%, at that juncture. You know, if I can spot a technical rally, then it's plain as the nose on your face. The stuff I usually do is more structural and long-term, economic. So it was clear-

ly coming, but now it's over. I know James thinks it's voodoo, but the technical analysts say the failure at the 200-day moving average was pretty bad. A nice little upturn had been in place since March, but we broke through that yesterday [5/21]; we're on the way back down.
James: I love it when you use chicken entrails.

Be nice, now. James, haven't you ever considered that technical analysis might be a useful system for gauging the market's emotional temperature?

James: I guess there's an element of that there. But in some regards I see it as a sort of self-fulfilling prophecy. The more people look at it, the more truth it holds. There are definitely an awful lot of followers of technical analysis. I just I have a problem with it because statistically, it doesn't seem to work very well; that's always a bit of an issue for me. There are plenty of very intelligent people who use technical analysis, though, so it obviously works for them. But that's not to say I disagree with Albert's pessimism. I don't. When you look at it, the underlying fundamentals are appalling. Economic growth is crumbling and the market is still hideously expensive. That is the real issue, and people tend to forget that valuation is a *binding* constraint, albeit only long-term. In the short-term, we know that markets can become more expensive.

Yet the sky-high valuations didn't act as much of a constraint in '98-'99, say.

James: Absolutely not.

Nor do they seem to be constraining the oil market currently.

James: No. Some of the basic materials are just manic. But they're a perfect example of what I think is the most common fallacy that we encounter, which is overpaying for growth. Or, at least, overpaying for the *hope* of growth. One of the things that I've observed recently is that the year two forecasts on the basic material sectors have switched. Normally, year two forecasts are below year one forecasts for basic materials companies because everybody expects the prices in the spot market to come down. But what we've actually seen in the last couple of months is year two forecast growth go above year one forecast growth. So we have a situation where people are beginning to buy into "this time really is different." That changes the dynamic of the market, from my perspective.

How so?

"The fundamental business of the country, that is production and distribution of commodities, is on a sound and prosperous basis." - President Herbert Hoover, October 25th, 1929
"They have lost a few tail feathers but in time they will grow again, longer and more luxurious than the old ones." - The Wall Street Journal, between Oct 24 and Oct 29, 1929
"The investor who purchases securities at this time with the discrimination that as always is a condition of prudent investing may do so with confidence." - New York Times, October 28, 1929
6. "This is the time to buy stocks. This is the time to recall the words of the late J. P. Morgan... that any man who is bearish on America will go broke. Within a few days there is likely to be a bear panic rather than a bull panic. Many of the low prices as a result of this hysterical selling are not likely to be reached again in many years." - R. W. McNeel, market analyst, as quoted in the New York Herald Tribune, October 30, 1929
"Buying of sound, seasoned issues now will not be regretted" - E. A. Pearce market letter quoted in the New York Herald Tribune, October 30, 1929
"Some pretty intelligent people are now buying stocks... Unless we are to have a panic -- which no one seriously believes, stocks have hit bottom." - R. W. McNeel, financial analyst in October 1929
7. "The decline is in paper values, not in tangible goods and services... America is now in the eighth year of prosperity as commercially defined. The former great periods of prosperity in America averaged eleven years. On this basis we now have three more years to go before the tailspin." - Stuart Chase (American economist and author), NY Herald Tribune, November 1, 1929
"Hysteria has now disappeared from Wall Street." - The Times of London, November 2, 1929
"The Wall Street crash doesn't mean that there will be any general or serious business depression... For six years American business has been diverting a substantial part of its attention, its energies and its resources on the speculative game... Now that irrelevant, alien and hazardous adventure is over. Business has come home again, back to its job, providentially unscathed, sound in wind and limb, financially stronger than ever before." - Business Week, November 2, 1929
"...despite its severity, we believe that the slump in stock prices will prove an intermediate movement and not the precursor of a business depression such as would entail prolonged further liquidation..." - Harvard Economic Society (HES), November 2, 1929
8. "... a serious depression seems improbable; [we expect] recovery of business next spring, with further improvement in the fall." - HES, November 10, 1929
"The end of the decline of the Stock Market will probably not be long, only a few more days at most." - Irving Fisher, Professor of Economics at Yale University, November 14, 1929
"In most of the cities and towns of this country, this Wall Street panic will have no effect." - Paul Block (President of the Block newspaper chain), editorial, November 15, 1929
"Financial storm definitely passed." - Bernard Baruch, cablegram to Winston Churchill, Nov. 15, 1929
9. "I see nothing in the present situation that is either menacing or warrants pessimism... I have every confidence that there will be a revival of activity in the spring, and that during this coming year the country will make steady progress." - Andrew W. Mellon, U.S. Secretary of the Treasury Dec. 31, 1929
"I am convinced that through these measures we have reestablished confidence." - Herbert Hoover, Dec. 1929
"[1930 will be] a splendid employment year." - U.S. Dept. of Labor, New Year's Forecast, December 1929
10. "For the immediate future, at least, the outlook (stocks) is bright." - Irving Fisher, in early 1930
11. "...there are indications that the severest phase of the recession is over..." - HES, Jan 18, 1930
12. "There is nothing in the situation to be disturbed about." - Andrew Mellon, Feb 1930
13. "The spring of 1930 marks the end of a period of grave concern... American business is steadily coming back to a normal level of prosperity." - Julius Barnes, head of Hoover's National Business Survey Conference, Mar 16, 1930
"... the outlook continues favorable..." - HES Mar 29, 1930
14. "... the outlook is favorable..." - HES Apr 19, 1930
15. "While the crash only took place six months ago, I am convinced we have now passed through the worst -- and with continued unity of effort we shall rapidly recover. There has been no significant bank or industrial failure. That danger, too, is safely behind us." - Herbert Hoover, May 1, 1930
"...by May or June the spring recovery forecast in our letters of last December and November should clearly be apparent..." - HES May 17, 1930
"Gentleman, you have come 60 days too late. The depression is over." - Herbert Hoover, responding to a delegation requesting a public works program, June 1930
16. "... irregular and conflicting movements of business should soon give way to a sustained recovery..." - HES June 28, 1930
17. "... the present depression has about spent its force..." - HES, Aug 30, 1930
18. "We are now near the end of the declining phase of the depression." - HES Nov 15, 1930
19. "Stabilization at [present] levels is clearly possible." - HES Oct 31, 1931
20. "Executive Order 6102 Forbidding the Hoarding of Gold Coin, Gold Bullion and Gold Certificates...to provide relief in the existing national emergency in banking, and for other purposes", in which...I, Franklin D. Roosevelt...do declare that said national emergency still continues to exist and...hereby prohibit the hoarding of gold coin, gold bullion, and gold certificates within the continental United States...." - Franklin D. Roosevelt, The White House, April 5, 1933

Source: <http://www.cjseymour.plus.com/finan/prognost.htm>

“The IEA has cut their forecast for oil demand again and again, compared to where they were at the beginning of this year, and yet the price has totally detached itself from those fundamentals. So for me it is clearly a speculative phenomenon.”

James: A lot of what we’d seen previously had been what we’d termed a “cynical bubble.” Meaning that people didn’t really believe what was going on, but were prepared to go with it because it was in their best interest to do so; the relative performance kind of stuff. But this now looks much more like a bubble of belief, which is exactly what we saw in the tech sector in ’98-’99, where you got these ridiculous methods of valuation appearing, such as price per click and price per eyeball, and that sort of thing. I don’t know what the equivalent in mining is, price per tractor tire perhaps, or something else that seems can be used to justify almost any growth expectation. But that’s exactly what we’re seeing now. We’re seeing a bubble of belief build that this time really is different; that there is some long-term opportunity within the emerging markets. Both Albert and I – Albert from fundamental and liquidity points of view and I from a market view – have issues with the notion of decoupling. I just don’t see it. People always, classically, forget about lags at turning points. And if your chief export market implodes, which is potentially what we’re going to see the U.S. consumer market doing– if it’s not already done so – it’s hard to imagine why you’re going to continue to see export growth. There are an awful lot of fallacies that surround the emerging markets and the basic materials, too. And these things aren’t cheap. Emerging markets are trading on a 40 times cyclically adjusted P/E. Back in 2003, they were at 10 times cyclically adjusted P/E. As uncharacteristic as it is to imagine, I actually got bullish on emerging markets back in ’03 because they were cheap. But now we find that the reverse is true. Now that everybody else wants to buy them– and is willing to pay top dollar for them – I sit here and think, “No, I’d rather not.”

Albert: That’s right. All I’d add is that from the commodities side what has surprised me, as I have written, was that when I looked at some of the commodities indices, because I was sort of relating the CRB to world growth, it’s only been in the last six months or so that the CRB has totally detached from the cyclical slowdown we’re seeing and gone potty. And when I actually looked at some of the industrial commodity indices that exclude oil, like the *Economist’s* industrial baskets, which includes agricultural industrial commodities as well as metals, and the IMF industrial commodity index, they’re actually flat year-on-year, which, to be honest, surprised me. So I dug around a bit more and then found out – because I don’t keep my eye on

these things all the time – that actually things like lead, zinc and nickel are down about 50% from their peaks. As always, as James says, people reach for growth, so as these sort of cyclical risk dominoes tumble, they funnel into the remaining stories that haven’t yet been disproved. What is interesting is that this is now very much a food and energy bubble. All the speculation seems to have funneled in, even within the commodity complex, to food and energy, just those few commodities. Obviously they are key commodities. But the oil price – before I left London to come out here I read through a stack of newspapers from this week, and saw an interesting article in the *Wall Street Journal* saying that actually there is a glut of spot oil. Some Gulf states are hiring tankers to basically park their surplus oil in the Gulf, because they can’t find buyers for it.

Right. There’s reportedly an immense amount of inventory afloat in the Gulf.

Albert: And the demand isn’t there for it at the spot end. As James always says, pricing commodities, unlike equities or bonds, is very difficult. You might agree with the structural argument, but where does that mean that *the price* of oil should be? Should it be at 200? 400? 60? It actually doesn’t tell you where oil should be. Certainly *nothing* has changed structurally in the last six months. Oil has rocketed up, yet the only cyclical phenomena which has changed is that the IMF forecast for global demand this year has absolutely plummeted. The IEA has cut their forecast for oil demand again and again and again, compared to where they were at the beginning of this year, and yet the price has totally detached itself from those fundamentals. So for me it is *clearly* a speculative phenomenon. I mean, you had the Goldman oil guy coming out saying “buy,” forecasting \$200 on the long-dated contracts. Lo and behold, they jumped \$10-\$15 because everyone piled in. But I don’t see it. What people forget is that *there is always a structural argument*. They said in the U.K. that house prices could not fall because there is a shortage of land and we are having all this immigration. Lo and behold, cyclically house prices have just collapsed in the U.K. But the structural argument hasn’t changed. I see the situations in oil and food as similar. I am a structural bull on commodities. But hey, I see the cycle turning, and I think, “No, this has just gone a bit potty.”

It’s silly season. I saw a headline this morning saying that the IEA is about to slash its

forecasts of peak production capacities –

Albert: Sure, that's a methodology change, just like Moody's has to keep doing. On the way up, methodologies are changed to justify higher prices. When we're back at \$60, and given a global recession, we will be back at \$50 or \$60 in a year's time, they'll be changing the methodology back again.

James: That's the equivalent of moving up the income forecasts to try to justify valuations. One of the things about commodities that I don't think is getting anywhere near enough attention is the whole idea that because people have suddenly seen commodities as an asset class, and you have had these huge institutional investment inflows into commodities, those inflows themselves have changed the structure of the markets. If you're investing in futures, which most of these funds tend to do, it used to be that the market was generally in backwardation, so you collected a positive roll on your contracts. But now, because these guys have driven up the spot prices so much, a lot of these markets tend to end up in contango, which means you get a negative roll. That means that you've got to make 15%-16% per annum in price move – just to cover the negative roll. The consultants missed that. The very process is sort of a demonstration of the **Heisenberg Uncertainty Principle**; you cannot observe without influencing. These guys have forgotten that their own actions matter. It's poker, not roulette, that we're playing here. The behavior of others, their actions, have an impact on the outcomes.

Albert: One other thing that I like to point out is the liquidity effect on commodities and emerging markets. We've had one liquidity bubble go pop with the credit crunch. But there's another one still to unravel, which is the change in the U.S. current deficit. While it was blowing out, it acted as a huge liquidity pump for the rest of the world because the emerging economies intervened to hold their currencies down. So a chart of EM reserves goes up vertically and hasn't come down yet. But what I am highlighting is, hey, if the U.S. economy is going into a recession now, which it probably is, then we're moving to a different phase. Housing was the least import-sensitive component of U.S. domestic demand. So the housing crash hasn't really impacted the trade deficit all that much in the U.S. But now the credit crisis' impact is moving into consumption, which is the *most* import-sensitive component. So it's likely that you're going to get a *rapid* decline in the U.S. current account

deficit over the next 6 to 12 months, which means the emerging economies' surpluses come down very sharply, so they don't have to intervene so much in their currencies – which means the growth in their money supplies collapses, which means the growth of liquidity in their economies collapses. Any analysis of what drives emerging market growth rates and emerging market equities and bond performance, shows that the printing of money by these emerging economies' central banks has been a huge factor in bolstering their economies. But that is going into reverse in the next 6 to 12 months, in a major way. The reserves will still grow, but at a much, *much* slower rate. That will produce a big sucking noise in terms of the impetus for emerging market growth, and actually put downward pressure on commodities. If you blow up the emerging market growth story, then you kick away the crutch for the secular bull market in commodities *for a while*.

Not to mention, demolish decoupling.

James: I actually have come up with a wee bit of data that shows, even if you somehow still believe in decoupling, that the emerging markets still have a huge problem: There's an inverse relationship, historically, between economic growth and stock returns in emerging markets. The slowest-growing emerging markets have generally generated the best stock market returns for investors, while returns from the fastest-growth emerging markets have lagged, *because people overpaid for growth*. Yet the whole reason, today, for buying into the emerging markets and commodities seems to hinge on rapid growth in China, India, Brazil and Russia – which I think is utter madness.

There seems to be a lot of that going around–

Albert: Yes. Another thing we've flagged on this, which we find amusing – because so many pin their bull stories for commodities on demand from China and India and so on growing so fast, even if the U.S. and U.K. fall into recessions – is that the IMF came along several months ago and dramatically *reduced* its estimates of the emerging markets' purchasing power parity. They actually *cut* their estimates of the relative size of the Indian and Chinese economies by 40%. They shrunk them, overnight, by 40%. James has a name for it, the way you reject information which doesn't agree with your view.

James: Confirmatory bias.

Albert: Yes, well, I was staggered at the time, but that story just did not get picked up.

On that score, how much have you heard, amid all the stories about soaring food prices, about the tumble in wheat futures?

Albert: Yes, it's the same sort of thing. Anyway, not only have the emerging markets not decoupled, but they'll get this double-whammy. Export growth will slow dramatically and they'll suffer liquidity effects on top of that. So people will be astounded how much the emerging markets slow down over the next 12 months. As James said, it wouldn't matter if they were cheap, but he recently ran price vs. trend earnings for the emerging markets and showed they were anything but.

James: That exercise just showed how hideously expensive they are, and that's a trait that is common across markets today. It's not even just unique to the emerging markets. I just can't find very much that's attractive. It doesn't matter whether I'm looking top down or bottom up, either way, things look actually rather expensive.

But that's because you insist on acting like an old fuddy-duddy and measuring valuations against things more palpable than fantasy forecasts.

Albert: Yes, don't you realize that the cycle's been abolished? You don't have to measure a reversal to trend earnings anymore.

James: That's right, if the cycle is dead, everything makes perfect sense.

Albert: What was striking when James did a short screen recently— One of the things we think is hugely different from 2001 is that there were a lot of cheap stocks around during the tech bubble but it's staggering how few he found when he did those screens recently. And, conversely, he found the highest-ever number of stocks passing his shorting criteria.

James: It just demonstrates the point I'm making about markets being expensive here. In 2000, it was relatively easy to populate a portfolio of cheap stocks because the market was enormously polarized. You had your madness in TMT, and then you had a whole bunch of old style, old industry, old economy stocks that were dirt cheap. Whereas today, a very broad base of stocks is expensive. So when I do the short screens, we're seeing double or triple the level of shorts that we would normally find. The opportunities are very much on the short side, which shows how broad-based the overvaluation is within the marketplace.

Yet I hear people all the time comparing valuations to the tech bubble and declaring stocks, "Cheap." Isn't there a neuroscience explanation for that behavior?

James: Absolutely. It's classic anchoring. This whole habit of hanging onto irrelevant benchmarks. That's exactly what you're seeing. People say things like, "Well, 24-25 times Ford's earnings is perfectly reasonable." That was the peak they reached in the bubble. Today, at 13 times, even if I believed the Ford earnings forecasts, which clearly we don't, you'd have to question whether those numbers are actually cheap. Relative to the peak in the bubble, yes. Relative to a decent long-run history, clearly, no. That's the problem. People have very, very short-term memories here. We've got a serious myopia problem within the markets. The analysts are just in cloud cuckoo land. They keep telling us that things are going up. I do a chart of actual earnings and forecasts, which shows that the analysts very clearly lack reality. They only ever change their minds when there is irrefutable proof they are wrong, and then they only change it slowly. It's a classic pattern of anchoring and slow adjustment that we see.

Don't be too hard on them. Most are only parroting what the companies tell them.

That's it. The analysts turn around and say, "Well, the companies aren't seeing it." But no company *ever* foresees a slowdown. When was the last time that a company management said, "Things are getting tough out there and we're going to have a pretty horrid time?" It just doesn't happen.

Exactly. Managements are also the last to see an upturn. They're lagging indicators.

James: Absolutely. It's classic behavior. But people never acknowledge it. My favorite example is a tech company that actually came out and said, "A recession would be great for our business because it'll speed up the adoption of our software package." That was just classic. It was like a science experiment where you get rats together and dose them with radiation. Then you say the ones that survive are stronger. While they're stronger than the ones that didn't survive, they aren't stronger than before you irradiated them! The guys running these firms are doing the same thing, saying, "It'll be fine, We'll get a bigger market share." Yes, but of a much smaller market. That is the bit they forget. There's a fallacy of composition out there.

There's a classic instance in this morn-

ing's papers. **A couple of U.S. retailers came out with dismal earnings, year-over-year. But the stories led with the "great news" that they beat expectations.**

James: It's such a facile game. They beat expectations that were set a week and a half ago. Whoopee do. If they didn't, I'd be really terrified. But if you look back six months, 12 months, they fell *massively* short of *those* expectations. The whole idea that beating expectations is at all important for a business also worries me. Because it means that management is just obsessed with the share price rather than actually looking at what it should be doing, which is running the underlying business itself.

Oh, come now. That's a hopelessly quaint notion.

James: Yes, I'm deluded as ever.

Albert: We do know that management's biggest concern is their share price, because they've got options, so how and what can they do to keep our share price up. You might have seen Andy Lapthorne's piece this week [5/21], in which he did a very interesting quantitative analysis about the farce of the reporting rounds. It showed how in every reporting round, there's a surge of upgrades relative to downgrades and that once the reporting round is over, it swings back down again. It's just incredibly manipulative. I told him to call the piece, "Cheating," because it *is* cheating. Eventually it catches up with you, but you just try to keep the balls in the air as long as possible. Well, hey, if we have a deep recession, all the balls will be on the floor.

James: You see it now with the banks. They're trying to move away from mark-to-market accounting. It was all very well when we moved to mark-to-market accounting. Everyone said, "It's transparent, it's clear. Now, all of the sudden, the banks are saying, "Actually we'd prefer if we didn't have mark to market."

There's a critical difference. They liked transparency when the market was going up. But now it's going down.

Albert: Exactly. I laughed myself silly when I saw one of the regulators that oversees pricing for CDOs in the various tiers telling the banks, "Well, if it's a disorderly market, you don't have to mark these to market." Hey, it was a disorderly market on the way up as well.

James: It's a bit like rogue traders. You only ever find them on the way down, strangely.

To be fair, at least some investors have figured out that to-the-penny earnings

management is suspect. Did you notice how ridiculous Jack Welch looked when he criticized Jeff Immelt for not being up to his old tricks at GE?

James: Yes, there is a growing appreciation of the problem, but unfortunately it's still there. We still get this daft guidance pattern and people hanging on it.

Albert: But we *need* the guidance. Otherwise analysts will have to *think* for themselves.

James: Exactly. They don't want to conduct independent thought. That has obviously been entirely discouraged. The analysts have become journalists. We must have one of the world's most expensive press corps, on that basis.

I'd argue it's worse. The press at least is supposed to try to present a whole picture, all the facts. Many analysts merely operate as PR agents – flacks – for the companies they "cover."

James: True enough. What we need is for people to wake up and say, "I don't really give a damn what happens this quarter, what I care about is long-term value – and that's all I care about." Instead we continue to play the quarterly earnings madness game.

Albert: Most analysts simply aren't prepared to stand out from the crowd, even if they have very different conclusions from what a company has told the analysts it's "comfortable" with.

James: It's certainly not in their interest.

What are they most generously rewarded for? Driving buying in their stocks.

Albert: Actually, one of the things James has noted about **SG** is that it has the highest proportion of "sell" recommendations of any house out there, which he is quite pleased about because he's pretty bearish. But it's difficult to get the analysts to do it.

James: Essentially, most are there to cheerlead and should be stripped of the title, "analyst," because very few of them are capable of analyzing anything.

To be fair, it's awfully hard to get a corporate executive to schmooze with you, if you've got a negative rating on his firm.

James: Absolutely. You lose access; you can't get into road shows. I understand the constraints. But to my mind, mindless cheerleading is totally antithetical to the process of investment.

You mentioned the Street's "conspiracy of optimism" earlier. Why are you so convinced there's worse yet to come from the

"Not only have the emerging markets not decoupled, but they'll get this double-whammy. Export growth will slow dramatically and they'll suffer liquidity effects on top of that."

“If a loose monetary policy and rapid asset price inflation were the route to economic prosperity, Argentina would be the richest country in the world by now.”

credit crisis?

James: From my perspective the whole idea of the credit crunch could be seen in the Fed’s senior loan officer survey. There’s not only a supply of credit constraint, banks not willing to lend, there is a *demand* constraint. Nobody wants to borrow. So you have a market that is dead on both sides. That is a hallmark of a classic precursor to a liquidity trap whereupon the Fed’s actions have no power at all. You can raise rates, you can lower rates, and it really doesn’t make a damn bit of difference, because nobody is trying to borrow anyway. This is the problem. What you had was a multi-year Ponzi scheme that created an *enormous* debt burden. It’s the unwinding of that credit bubble that is the real handicap here. And that’s what people aren’t “getting,” if you like, because we don’t see these things very often. We don’t see a credit bubble bursting every day of the week; people aren’t used to it. And we know that people aren’t good at looking for change. It’s what we call “change blindness,” and we see it a lot. So what people haven’t got a handle on is that the environment is *structurally different*. There *has* been a bursting of the housing/credit bubble. And that *matters*, because it has real economic impacts, which I’m sure Albert will be able to talk about far better than me.

That sounds like a challenge—

Albert: No, that was great. What people don’t generally get is that the credit bubble was the flip side to the economic bubble – keeping growth going at all costs. The process of keeping growth going involved the U.S. household sector, and the U.K.’s and Spain’s, as well, piling up *huge* debts. That process *needed* asset price inflation on the other side of the ledger for them to borrow against. So you had incredibly loose monetary policy (however much **Greenspan** says he couldn’t do anything about it). You had double-digit broad money supply growth for about a decade in the U.S., way outpacing GDP, to keep asset prices going up. So sure, asset prices went up. And it’s perfectly rational for people to borrow against rising asset prices. But all you have to do is stop the music with asset prices, and the whole thing comes tumbling down, because you haven’t got anything to carry on borrowing against. We’ve got a measure of household sector savings, not the normal savings ratio, which everyone knows is at zero. We deduct household residential investment from that savings total and what we find is that there was an enormous ballooning out, over the Greenspan years, of the total

household savings deficit. It got to a 6% deficit, as a percentage of GDP. What that meant was that to keep the *level* of spending so far above income, you had to increase debt massively. Each and every year, you had to increase your debt income ratio, just to maintain your *level* of spending. The level, not the rate of change.

In other words, each dollar of new debt was less efficient than the last in generating growth—

Albert: Exactly. As I always say, if a loose monetary policy and rapid asset price inflation were the route to economic prosperity, Argentina would be the richest country in the world by now. This is a Ponzi scheme, and the U.K. has been doing the same as the U.S. It’s a bit like 2001, when the corporate sector also borrowed very heavily on a new paradigm view of the world. They piled up debt because they thought profits were going to explode. Then they sat bolt upright in 2001, realized they’d borrowed way too much and had to cut back on their borrowing. The U.S. economy just dropped out of the sky as they cut back on their investment – which they had to do, to stop borrowing. Now, the same thing is happening with the U.S. and the U.K. consumer: The asset price bubble has burst, and now there’s nothing there holding up these extremes of expenditure. Which is why I expect a deep recession. It surprises me, when we go around visiting clients, that not more people are thinking a deep recession is possible.

See, you are gloomier than most—

What we tend to hear is that it’ll be only a shallow recession, or perhaps a prolonged, shallow recession, if they use the word at all. Even guys who have been ahead of the curve, like the **Merrill Lynch** economists and the **Goldman Sachs** economists, who have the right idea of what’s going on, are still calling for a shallow recession. There hasn’t been a deep U.S. recession since 1982, and before that, ’74. Now, I define a recession by looking at a four-quarter moving average of GDP. In those recessions, GDP fell 2% year-on-year. If you look at the last recession, in 2001, on a four-quarter moving average basis, GDP did not decline, and in 1990-’91, I think GDP fell by 0.25% on that basis.

And most consumers sailed through those downturns unscathed.

Albert: Kind to consumers, unkind to corporates. The high-yield corporate default rate went to 12%. Now, Moody’s did a scenario analysis recently and they said in their *most pes-*

simistic scenario the default rate would go back up to where it was in the last two recessions. But those were *mild* recessions. And that may be what happens. But if you're going to pencil in a pessimistic scenario, why don't you pencil in a deep recession where default rates won't stop at where they went to in the last two recessions, around 12% for the speculative grade, but go to 20% or higher, which is what will happen if there's a deep recession? So Moody's hasn't learned. You know, the lesson from the AAA ratings of CDOs was its mistake in not factoring in the possibility of a deep housing downturn. Yet they're making the same sort of mistake again, by not factoring in the fact that there could be a deep recession. Well, why not? Why not simulate what would happen and warn people that the AAA stuff that is *not* CDO-related will come under incredible pressure if there's a deep recession?

You are a party pooper.

Albert: Yes, it seems quite impolitic to express a view like that. But deep recessions happen. Luckily for the U.K., its housing market and the household sector have gone through a deep recession more recently than the U.S. After the excesses at the end of the '80s, we actually had a deep recession in the early '90s. So at least we have had more recent experience. In the U.S., it has been so long that people just are not even thinking. I am not saying they have to make a deep recession their central case, but they should at least concede there's a 20%-30% chance of one. Granted, it is *my* central case, but it amuses me that people just aren't even considering the possibility.

Not to worry. The Fed fixes all.

Albert: That's just it! It's beyond the potency of the Fed. They *aren't* in control of it. **Paul Volcker** actually said recently that maybe the Fed lost control. There are so many people saying, quite rightly, that this is the most serious downturn since the Great Depression. Yet almost every forecast calls for a mild downturn.

You're putting your finger on a real disconnect. But again, it's in nobody's best interest to scare the daylight out of people.

Albert: I absolutely agree; there's behavioral bias throughout the whole industry. But then you think, we're actually *paid* to at least countenance the range of possibilities. Besides, it certainly won't be in the pensioners' interests, if pension funds' stockholdings go through the floor because people couldn't envision that it

could happen.

Not to mention their commodities holdings.

Albert: Well exactly. That's a structural bull market they've just *had* to enter. Funny how they've diversified into commodities now and if that bubble bursts at the same time as equities – If the equities markets take the sort of hit we're thinking about, even without the de-ratings that will take place if our Ice Age thesis pans out, then you're going to get an awful lot of balls being dropped on the floor and people looking very surprised.

I know you've been talking about an approaching "Ice Age" for around a decade, but what's that signify to you now?

Albert: James articulates it in a slightly different way, just focusing on cyclically adjusted market valuations being at such extreme levels. But the key thing I've been saying is that I still think it's a world of low inflation. People will be surprised, especially as commodities come back. Core inflation is incredibly low, incredibly well-controlled, considering we just had this phenomenal supposed commodities boom. Core inflation is below 2% in the U.K. and in the eurozone. It's around 2% in the U.S.

That may be your most contrary view of all at the moment. Have you looked at the price of gasoline or food lately?

Albert: Of course, I know that premium gasoline is already at \$4 a gallon in the U.S. and regular isn't far behind, but to the extent that central banks, like the ECB and the Bank of England, stay on hold because they worry about headline inflation, they're misguided. Headline inflation is just *crushing* purchasing power. We're more relaxed on inflation than most, probably, because as I noted at the outset, the main determinant of inflation is unit labor costs, 75%-80% of the total. What is different from the '70s is that back then going into the recessions a wage-price spiral took hold. And there's nothing of the sort at the moment. Inflation is slowing down because of the unraveling in the labor market, especially in the U.S. It's quite clear in a lot of the corporate sentiment indicators that companies are cutting back on their labor. Obviously, we all know about the government's payroll numbers being inflated by the birth/death model. But when you look at series like jobs hard to get or jobs plentiful you see a quite pronounced unraveling in the labor market. Now, had food and energy been spiking like this a year ago, when labor mar-

kets were far more perky, then the policy makers would have been right to be far more concerned. But not now. That moment has passed. By suppressing growth and allowing unemployment to rise, they will just make the downturn that much worse. Granted, I argue we're long overdue. And that we need a recession to blow off a lot of the excesses. But it'll be a lot worse than it would otherwise have been if the policy makers persist in jumping at shadows here.

Just how ugly are you expecting the recession to get?

Albert: Well, U.K. core inflation is 1.4%. Headline inflation is 3%. In a year's time, if we get a deep recession and the oil price buckles its way back to \$60, even with food inflation still where it is, I calculate that produces zero headline inflation in the U.K. And it would work out about the same in the U.S. Now, what no one else really is saying is, "Hang on, if all this is a bubble and the bubble has burst, we could get a real flip over back to *deflation* worries if headline inflation collapses. Again, we've got a minority view on that, but markets do flip flop.

No argument. But oil back down at \$60?

Albert: Yes. Think what the oil price might be in a deep recession in which the emerging markets go down. Emerging markets earnings optimism is crumbling just as quickly as the developed markets. There's no decoupling at all, so if you've got a sharp slowdown in growth in China and in emerging markets generally, I think perceptions will be totally transformed in six months' time. But all you can do is sort of warn of these things. And obviously people want to go with the flow. So stagflation is trendy again. I mean, if unit labor costs were picking up quite briskly the inflation bulls would have a very good case, but they are going in reverse.

Okay, but inflation expectations are soaring, and they're supposed to lead—

Inflation expectations can go up – and they are. But you go and ask for a pay raise and see what happens. Very little. I mean if these statistics are right, and I think they are because they survey the wage data, wage inflation is falling. Real incomes have just been absolutely clobbered. Which makes a consumption recession much more likely, which means that the emerging markets will see their current account surpluses shrink, which means the emerging markets are more likely to feel the double-whammy I mentioned earlier. And the inflows into their sovereign wealth funds will slow dramatically,

because their foreign exchange reserves will stop growing. So we're saying with a slowdown in the emerging economies, that money is far more likely to stay at home and be put to use on infrastructure projects than to come back here to bailout Western banks.

What would that mean for the dollar?

Albert: The surprising thing could be that as the economy slips into deeper recession over the next six to 12 months, the dollar actually rallies. For two reasons: 1) Because interest rate expectations start to fall elsewhere quite rapidly, and that's already starting to happen. 2) If we do get the sharp fall I expect in the U.S. current account deficit, it's quite likely that the markets will focus on that and we'll have the dollar showing surprising strength in a period where the U.S. doesn't really want the dollar to be strong.

How much improvement are you talking about in the U.S. current account deficit?

Oh, it was 6% of GDP. It's 4%-5% now, I'd say that if it drops to around 1%-2% in the next 12 months, it could have a big impact on the dollar. Japan has had that problem repeatedly, and often has had to intervene very heavily to stop the yen from going up when the economy was in trouble. To the extent the dollar does rally, the less intervention the emerging economies will have to do to stop their currencies going up – and that will squeeze their reserves and money supplies even more. A bull in the china shop is unwelcome, as they say, and that would be a most unwelcome dollar rally from the point of view of the U.S., really turning off what has been a global liquidity pump. The lesson from Japan is these things can happen, especially if your economy is heading towards the rocks.

Surely you know the U.S. is just is not like Japan in very many ways.

James: Yes, but **Peter Tasker**, the Japan specialist we used to work with at DrKW, always used to say that the U.S. will eventually start to suffer something similar to Japan's malaise, only worse because it's a more flexible economy.

Did you say worse?

James: Yes. At least in Japan companies didn't cut jobs, because there was no social security net. Companies hoarded labor in the downturn, which meant margins totally collapsed, and profits. But whole economy consumption never really collapsed because there weren't big drops in employment. In contrast, he said, the U.S. economy's greater flexibility will actually hurt

the overall economy in a downturn. Companies will aggressively defend their margins by cutting labor, which probably induces a collapse in employment, in consumption. So in trying to maintain their margins, actually revenues collapse, because purchasing power just evaporates. It's a fallacy of composition argument. What he was saying is that it could lead to a much more violent death spiral on the downside than Japan ever really had. Japan, if you like, merely had a long period of very meager growth. But he suggested that if push comes to shove, the flexible nature of the U.S. economy could produce an economic death spiral where consumption goes through the floor, profits go through the floor, and it's very difficult to turn it around. That's why the deflation argument in the U.S., which seems incomprehensible at this point, could become a very real reality in 6-12 months' time. So being "flexible" doesn't always produce a desirable outcome.

You two are conjuring up what have to be chilling prospects for central bankers – no wonder you call it the Ice Age.

Albert: What I've been saying all along is that in a low inflation world, equities should be cheaply priced relative to bonds. All we say to our clients is, if there is a recession, even a mild one, profits will fall 30%- 40% maybe. But people are counting on multiple expansion as bond yields come down to offset the lower earnings. What we're pointing out is that investors will *really* be surprised if we get a repeat of 2001-2003, where you get a recession and bond yields come clattering down, *and* you also get a forward P/E *contraction* from 13 times say, to 9 times. Plus, you get that *on top of* the profits recession. We still think we're in a secular bear market for valuations. And equities are still, as James says, hideously expensive on cyclically adjusted measures.

That's what happened, I dimly recall, back in the mid-'70s and early '80s.

Albert: Yes. And if you go back to the '50s and '60s, the whole market used to yield a lot more than bonds, not just a few stocks. I think that's what we're going back to. But mine is very much a minority view. So what we're saying to clients is to just hang on. Don't expect a bear market in a recession to be just 20% or 30% because of multiple expansion. You could get, in a deep downturn, market declines on the order of 50% to 75%, because you get the fall in profits and you get P/Es coming down. That's how, mathematically, you can get to a seismic

fall in the markets in the event of a decent recession. Nothing I've seen yet disproves that theory. Sure, the bulls also could still be right; maybe P/Es will expand to 18 times if bond yields come down to 2.5%. But that's just their postulation. They argue multiples won't contract again like they did in 2000-2003, because equities were ridiculously expensive then and the decoupling between bonds and equities was a one-off event. We're just saying that maybe it wasn't. And if so, watch out.

Wouldn't it be behaviorally, well, natural for multiples to contract in a nasty downturn, as people turn cautious?

James: Absolutely classic. That's what you saw in Japan as the Ice Age played out there: Multiple contraction with each subsequent downswing. I think that will be a feature of a post-bubble environment. Markets do become quite economically driven, if you like. The earnings cycle tends to matter much more. And we've barely begun an earnings downswing here. So I would fully envision a much sharper earnings decline that will make people that much more cautious. Now, after they lose faith repeatedly over the course of these ongoing cycles, eventually you do end up at the bubble process' end, which is revulsion. But it's slow getting there. It doesn't happen in the course of one market correction of 20% or 30%.

It almost sounds like you're saying it's "fate."

James: No. As I wrote a few months ago, the events unfolding in the U.S. aren't a black swan but an example of a predictable surprise. To claim otherwise is to abdicate all responsibility for what's happening – and I believe bubbles are a by-product of human behavior – which is (sadly) all too predictable. Of course, the details are different in every instance, but the general model was laid out long ago by **Charles Kindleberger** and **Hyman Minsky**: Bubble rise and fall in 5 stages – displacement, or the birth of the boom, then credit creation, euphoria, then crisis/financial distress and finally revulsion. We're not close to that last stage yet – and the path to it is never straight; always includes plenty of sucker rallies, as the quotations we talked about earlier so amply demonstrate.

One thing I hear constantly, so you must, too, is that there's still so much liquidity looking for a home that the markets *have* to be sitting pretty.

James: We definitely hear a lot about liquidity and a lot about sovereign wealth funds. But a

"A long time ago I wrote that liquidity is the name that investors give to their ignorance, and I continue to stand by that."

long time ago I wrote that liquidity is the name that investors give to their ignorance, and I continue to stand by that. When you can't find anything else to explain what's happening, you say it's liquidity. You might as well say there are more buyers than sellers because it is at least as true, scientifically. A lot of what we see here is just excuses being made. A lot of it isn't genuine monetary creation like Albert was talking about earlier is in the emerging markets context. A lot of what you're referring to is really the fallacy of liquidity, this idea that there's a lot of money sloshing around and it's got to find a home. As our mutual friend **John Hussman** always points out, all you've got is really Paul selling to Peter. It doesn't alter a damn thing if I buy a stock and someone else sells it. The net amount of money entering or leaving the market is essentially zero. **Albert:** What the "liquidity" everyone talks about really is, is leverage. If there's price momentum, you want to borrow and play that price momentum – often in cyclical risk assets. But as soon as that momentum turns, like the *Roadrunner*, liquidity may continue running off the cliff for awhile, but eventually gravity takes hold. Prices re-couple with the cycle. And as we've seen with CDOs, liquidity just evaporates overnight. That's the problem with relying on liquidity as an investment tool. It's just basically a leveraged momentum trade, which can explode in your face. Now, some of these private equity people are still able to raise money – that's what's so amazing. But liquidity essentially can evaporate overnight, as we've seen with the CDO market.

And leverage can turn vicious, as Bear Stearns learned the hard way. The banks and brokers wouldn't be having all the rights issues James was complaining about earlier, if they weren't way too highly leveraged.

Albert: Yes, but to be fair, if you're going to do a rights issue, you might as well try and do it in a bear market rally. I pity the ones who'll have to try to do it in a month or two's time, if the market's heading back down again. Maybe the underwriters will end up with some of it on their books. They've been getting big fees – and lots of criticism – for underwriting these deeply discounted rights issues. But if the market starts dropping away again very sharply, a lot of

that stuff could end up on the underwriters' books. Which could certainly change the tune of the market. The last thing the banks want is one of their competitors' shares sitting on their books in a bear market.

The irony, at least, would be rich. Thanks, gents.

Welling@Weeden Staff Conflicts Avoidance Policy Disclosures

In keeping with Weeden & Co. LP's reputation for absolute integrity in its dealings with its institutional clients, welling@weeden believes that its own reputation for independence and integrity are essential to its mission. Our readers must be able to assume that we have no hidden agendas; that our facts are thoroughly researched and fairly presented and that when published our analyses reflect our best judgments, not vested pocketbook interests of our sources, colleagues or ourselves. Neither Weeden & Co. LP nor w@w engage in investment banking; w@w's mission is strictly research.

All information gathered by welling@weeden editorial staff in connection with her/his job is strictly the property of welling@weeden. It is never to be disclosed prior to publication to anyone outside of welling@weeden. Editorial staff (a group broadly defined to include Kate Welling's immediate family) will not buy or sell any security mentioned in the journal for at least one week after publication. Staff will avoid not only speculation but the appearance of speculation and may not engage in short-term trading, the short selling of securities, or the purchase or sale of options or futures. Staff may not be otherwise compensated for securities recommendations in these pages. No w@w staff will serve as an officer or director of any publicly traded company. All securities positions entered into by w@w editorial staff will be held for *at least* six months unless dispensation is received, in extraordinary situations, from Weeden & Co. LP's compliance officer. Any securities position in any company, mutual fund or partnership portfolio featured in welling@weeden that was acquired by staff in advance of the publication decision will be specifically disclosed at first mention. [No such reportable positions exist.] And that position will be frozen for six months from date of publication, again, absent extraordinary dispensation from compliance.

Weeden & Co. LP's Research Disclosures

This material is based on data from sources we consider to be accurate and reliable, but it is not guaranteed as to accuracy and does not purport to be complete. Opinions and projections found in this report reflect either our opinion (or that of the named analyst interviewed) *as of the report date* and are subject to change without notice. When an unaffiliated interviewee's opinions and projections are reported, Weeden & Co. is relying on the accuracy and completeness of that individual/firm's own research disclosures and assumes no liability for same, beyond reprinting them in an adjacent box. This report is neither intended nor should it be construed as an offer to sell or solicitation or basis for any contract, for the purchase of any security or financial product. Nor has any determination been made that any particular security is suitable for any client. Nothing contained herein is intended to be, nor should it be considered, investment advice. This report does *not* provide sufficient information upon which to base an investment decision. You are advised to consult with your broker or other financial advisors or professionals as appropriate to verify pricing and other information. Weeden & Co. LP, its affiliates, directors, officers and associates do not assume any liability for losses that may result from the reliance by any person upon any such information or opinions. Past performance of securities or any financial instruments is not indicative of future performance. From time to time, this firm, its affiliates, and/or its individual officers and/or members of their families may have a position in the subject securities which may be consistent with or contrary to the recommendations contained herein; and may make purchases and/or sales of those securities in the open market or otherwise. Weeden & Co. LP is a member of FINRA, Nasdaq, and SIPC.

Welling@Weeden Interviewee Research Disclosure: Albert Edwards and James Montier are Co-Heads of Global Strategy of the Equity Research Team at Société Générale Cross Asset Research. This interview was initiated by Welling@Weeden and contains the current opinions of the interviewee but not necessarily those of Société Générale. Such opinions are subject to change without notice and no responsibility to provide updates is assumed. This interview and all information and opinions discussed herein is being distributed for informational purposes only and should not be considered as investment advice or as a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but is not guaranteed. In addition, forecasts, estimates and certain information contained herein are based upon proprietary research and should not be interpreted as investment advice, or as an offer or solicitation for the purchase or sale of any financial instrument. No part of this interview may be reproduced in any form, or referred to in any other publication, without express written permission of Welling@Weeden. Past performance is no guarantee of future results.