

THE ECLECTICA FUND

FUND MANAGER COMMENTARY

August 2009

Good people are becoming desperate. I know a man who is planning to capitulate and buy stocks. He cannot comprehend what is happening today. He is, to employ Churchill, a fanatic; he won't change his mind and he can't change the subject. But, fearing the loss of his franchise, he will change his portfolio.

He laments that it is as though last year's events never happened. Rhetorically, he asks whether we have all been sent through time to invest in equities at the end of the 1970s when stocks were cheap and society had thoroughly deleveraged (the opposite of today). "Why do other investors not contemplate the prospect of further household deleveraging when building their profit forecasts?" he fumes. "Can they not see that the private sector's deleveraging is more than offsetting the public sector's expansion?" Despite such ranting my Minskian friend remains a most entertaining and charming individual.

Now I know I have not covered myself in glory these last few months. Stock markets have gained 50% from their lows and the Fund has little to show for it except a modest reversal and no wild swings in our monthly NAV. Nevertheless, I would contend that this game of playing "chicken" with the market is not for us. Our ambition has been modest. To survive the onslaught of a positive change in social mood without being forced to capitulate in the face of a frenzy of optimism; so far so good, I think?

In this regard we have been helped immensely by a quote from Robert Prechter in early April. Having correctly called for a counter-trend rally in stock prices in late February, he then described the most likely nature of the advance,

"...regardless of its extent, it should generate substantial feelings of optimism. At its peak, the President's popularity will be higher, the government will be taking credit for successfully bailing out the economy, the Fed will appear to have saved the banking system, and investors will be convinced that the bear market is behind us."

So far his prophecy reads well. It is reminiscent of Warburg's line that the business cycle is "a subject for psychologists" rather than economists. Bernanke is already being compared favourably with Volcker. Continental Europe has apparently "escaped" from recession. Positive economic growth across the world for the remainder of the year seems certain. And yet Prechter went on,

"Be prepared for this environment: it will be hard for most investors to resist. But beware... [the next move] will be the most intense collapse in stock prices"

This seems hard to reconcile with the determination of governments to resist the bear market; the more plausible Cassandra scenario remains something more akin to the long drawn out agony of the Japanese stock market. Nevertheless, let us assume that he is right, what could possibly generate such a black turn of events as to send stock prices back to challenge their March lows?

Notwithstanding, of course, a tapped out private sector, lingering high levels of unemployment, capacity utilisation levels which never rally sufficiently to raise industry profitability, a speculative orgy in China which is likely to burst at some indeterminate moment and the complete uselessness of fundamentals in determining turning points.

Apologies, I am susceptible to my friend's ranting after all.

Rain, rain, go away...

In attempting to answer the question of what could reignite a sell off in risk assets I have found myself returning time and again to my February 2006 investment report in which I drew the obvious parallels between the economic circumstances of the 1920s and today. The paper had the title, "Trees don't grow to the sky", and focused on the economic consequences of those periods when one country or region dominates world trade.

In the 1920s it was America in the ascendancy but something similar arose in the 1950-60s with the recovery in continental Europe, in the 1980s with the rise of the Japanese economy to preeminent creditor nation status and, of course, today with the rise in China. The one constancy is that unbalanced world trade has a tendency to pit domestic monetary policy considerations against international and, as a result of this tension, credit is created which fuels asset price bubbles and their resulting busts.

I want to spend some time reviewing such periods because I believe they suggest an outcome which challenges today's near universal fears concerning the US dollar. I believe they reveal something distinctly non-consensual: that weakness in global economic demand can force the most painful adjustments not on the "sinful" low savings trade deficit countries but rather on the "virtuous" high savings trade surplus economies.

Consider for a moment the economic disequilibrium left behind by WWI. Europe was saddled with debt and America had become both a creditor nation and a net exporter. If economic orthodoxy had prevailed, the US should have imported more and the Europeans, especially the Germans, should have exported more. Under this scenario, gold, the international reserve currency, would have flowed from the US to Europe, and financed the latter's reconstruction.

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But that is not what happened. First, through the transmission mechanism of the gold standard, the persistent economic weakness of Europe kept US domestic interest rates too low. And second, the US adopted a more mercantilist course dedicated to expanding its large export industries, rather than shifting resources to boost domestic consumption. In essence, the pro-cyclical gold standard created a huge pool of liquidity, or high powered money, and the private American banking sector was encouraged to lend generously overseas in an effort to maintain the status quo. Build it and they will come had become lend it and they will buy.

But such was the political intransigence concerning Germany's crippling war reparations, and the over-valued nature of Sterling, that Europe never fully recovered and the debt came to finance asset price speculation rather than productive investment. To make matters worse, the workings of the gold standard required the Fed to respond to the European downturn in the second half of the decade by slashing domestic interest rates in late 1927. This only served to galvanise the private sector's desire to take on yet more unproductive debt.

It was one thing to be a global economic titan confidently confronting the future with private debt of 175% of GDP but quite another when your customers were bankrupt. With liquidity no longer expanding at the same rate, stock prices crashed and the legacy of such a large quantum of private debt meant that deflation prevailed. Low interest rates and a pre-Keynesian but nevertheless substantial fiscal expansion were subdued by the private sector's rush to deleverage. In time, Milton Friedman and his acolyte, Bernanke, would reach a different explanation (see below).

But what are the parallels with today?

Once more the world has a creditor nation running a persistent trade surplus. This time, it's China and its Asian neighbours. However the amounts involved are much greater than any other comparable period. US current accounts had been range bound between minus 1% and plus 1% of GDP for the last fifty years. But in the last ten years the US has witnessed a blow-out with no historical precedent. In 2007 its deficit hit 7% of GDP. And with China recording a corresponding net current and capital account surplus, the People's Bank of China has cornered the market in dollar reserves just like the Americans had in gold by the late 1920s.

Trade also remains mercantilist in character. Since the Asian currency crisis of 1997, China and the others have replaced a dependency on foreign capital with a dependency on foreign demand. And like their American counterparts in the Twenties they are willing to lend their "client" countries this unprecedented pool of dollar money in order to ensure full employment at home in their large export industries. Furthermore, with the tie to the dollar, they have replicated the fault line of the 1920s' gold standard: domestic monetary policy has become pro-cyclical with real interest rates negative for most of the last ten years. As a result house prices in China have tripled between 2003 and 2008 despite their supposed high savings and a less leveraged financial sector.

One of the key objectives of a mercantilist trade policy, as we saw in the 1920s, is to sustain the health of the liquidity-donor's economy. In the 1920s, America used its accumulation of the world's gold reserves to buy sovereign debt issues and the Chinese have done something similar by investing their bounty of dollars into US Treasuries. Bernanke, and others, mistook this for a global savings glut. In actual fact it was a form of quantitative easing. As the Asians acquired more and more dollars from overseas trade they bought more and more Treasuries and printed more and more local currency just to prevent the appreciation of their own currency. Net flows from the Asian developing countries to the West, surged in a straight line to around \$700bn annually. This was then leveraged many times further by Wall Street (Goldman's 24x leverage compares modestly to the infinite leverage of the mortgage originators). All asset classes globally were propelled higher by this torrent of credit.

Revenge of the Triffids?

But what are the implications for today? As in 1929, these events are now behind us and it is their legacy which concerns me most. The global economic system is now bearing the brunt of having accumulated so much excessive private debt (275% of US GDP at its peak vs. 1929's 175%) and has borne a contraction in economic activity which is on a par with the initial stages of the Great Depression. Worryingly for global economic bulls, the US is no longer "spewing out its green emissions", as Warren Buffet describes the dollar, because the US current account deficit is falling rapidly. And yet the consensus is still for more dollar devaluation and more asset price inflation, i.e. for more of the last ten years.

This confuses me greatly. If you remember, in the original plot to the movie *The Day of the Triffids*, a sailor awakes in hospital following an eye operation to find the populace of London has been blinded by radiation from a freak meteorite and terrorised by carnivorous plants. I wonder if something sinister is not afflicting my fellow investors. Perhaps I have just been in slumber for too long? But can someone please explain how we can have more of the same price movements when the economic circumstances have changed so much? I believe investors have been blinded in their expectations by the age old dilemma of deploying a national currency as an international reserve asset. The Triffin Paradox states that the US needed to achieve the impossible over the last decade: it had to simultaneously run both a current account deficit and a surplus. Perhaps this better explains its price weakness. Continuous US current account deficits, as we discussed above, provided the Asian world with the liquidity necessary to rebuild their economies. However, the presence of so much dollar reserves at foreign central banks encouraged speculators to fret about a run on the dollar that could destroy its value; hence the 40% dollar devaluation.

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Rather than berate the dollar for having failed to achieve the impossible I find myself agreeing with Michael Pettis who argues that it is the US "who should be agitating for an end to the US dollar as the default reserve currency because this means that any time a country needs to grow reserves or turbo-charge domestic growth with mercantilist industrial policies...it is almost always the US tradable goods sector that is forced to adjust". And I find the notion that China should wish to revoke this golden goose as absurd. But regardless, the dollar debate could prove less contentious if, as I suspect, the deficit comes back to oscillating within its 50 year range.

Kansei Fuk-yo?

Today, of course, the US has stopped running such large balance of payments deficits; it is saving more. As a consequence, the international community has lost a large source of incremental liquidity. The domestic US economy on the other hand has been a direct beneficiary and the market for Treasuries has become more reliant on US buyers. For instance US households have more than doubled their bond holdings in the first quarter of this year. But the resulting shortage of global liquidity has ominous implications for the surplus countries that have so much invested in export industries. It is in trying to fill this void that world governments have resorted to the more recognisable form of quantitative easing in the West allied with huge fiscal spending in the East. But for my money it runs the risk of invoking the Japanese term, "kansei fukyo", a recession caused by the blunders of policy makers.

And the Chinese fiscal expansion conjures up the fatal American mistake of 1927 when they were obliged to loosen monetary policy for international not domestic considerations. The rate cuts amplified speculation and almost certainly contributed to the harshness of the downturn. Coming on the back of five years of rapid investment-led growth, could it be that the Chinese stimulus has the same effect in 2009?

It is not as if China has been immune to speculation. I had the opportunity to witness the commercial property bubble in March. You can see the blog at <http://www.youtube.com/watch?v=ektMQGbW3wk>. But I warn you that it is a seriously clandestine and amateurish piece of reportage.

Nevertheless it features one of the most formidable new buildings that I have ever come across. I would estimate the build cost must be in the hundreds of millions of dollars. And it wasn't located in Hong Kong or even Shanghai or Shenzhen, but in the decidedly less glamorous Wuhan in the centre of the country. And to make matters worse it was completely empty. You can tell the age of a building in China by counting the layers of pollution that the smog generates and it was obvious that this was probably a speculative new build that had outlasted its developer. I learned recently that the building now has a tenant, the \$20bn Minsheng Bank, but I suspect they lent the money to the developer in the first place.

Adding to the intrigue, I have subsequently been informed that our video has now been blocked in China by the authorities. Who would have thought that I would become an enemy of the state?

Regardless of my misgivings, the international rescue mission has opened up a key battle line in the economic debate between Friedman and his intellectual followers such as Bernanke, who attribute the 1920s crash to the central banking response to the crisis and what they claim were the authorities' anti-speculative measures, and their rivals who might be thought of as followers of the economists Irving Fisher and Hyman Minsky. They cite instead the build up of private debt preceding the drop in asset prices as the determining factor. My prejudices favour the latter interpretation which makes me sympathetic to the Australian economist Steve Keen's observation that, "Bernanke's dilemma is that he is living in a Minskian world while perceiving it through Friedmanite eyes." [1] When debt is modest, Keen goes on to say, changes from one year to another can be ignored but when debt is very large it can come to play a major role in fuelling the economy. And just as the growth in private debt from one year to the next came to have a disproportionately large impact on spending so its contraction could hamper the authorities' remedy; we will soon discover the answer.

Investment Strategy

Time passes so incredibly slowly when you are not making money and indeed there remains little to add since our last update: Minskian risk-averse profit strategies continue to suffer from ugly seasonality effects. Apparently, we must wait until at least the 15th of August; according that is, to a wise man I met in a café in Monte Carlo. He informed me that the French return from their lovers to spend more time with their families in late August and from then on a greater chill can be detected in the market place; who knows? But reassuringly the long end of the bond market has stopped registering new lows and this continues to be our largest risk exposure, representing 29% of the Fund's assets.

It remains impossible however to be precise concerning the timing of any turning points in the market place. Our strategy rather is to keep in check any drawdown with the promise of a strong contribution should events turn quickly our way. That is why we have anchored the Fund with a modest holding in government paper and put asymmetric bets in the tail which have tremendous pay-outs should the economy fail to gain enough traction over the next two years.

[1] <http://www.debtdeflation.com/blogs/wp-content/uploads/papers/NotKeenOnBailoutsFinal.pdf>

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These opportunities exist owing to the growing conviction that we are in the midst of a vigorous economic upturn and that interest rates will need to rise sharply over the next two years just to keep growth in check. In truth, the market for interest rate expectations has little time for unorthodox business cycle theories like Fisher's debt deflation; private debt at 275% of GDP? Not interested. What about the longest run of falling prices since the Great Depression? That is so 2008. What about Japan and its persistently low interest rates? Foreign nonsense; it could never happen here. How about quantitative easing? Ah, now you are talking.

Inflation is a monetary phenomenon and interest rates are sure to rise to combat this monetary mayhem. As you might have guessed we remain fascinated by the procrastinations of this market.

Consider the UK interest rate market. The Bank of England seems to concur with our caution. We mentioned our trading last time. But in the swaps market we can buy more time to await our predicted outcome. We recently purchased the right, but not the obligation, to receive a rate of 2.5% on one year money starting in two years time.

Now that is a lot of time. However when you listen to the musings of the central bank and consider everything that has happened over the last year it is not outrageous to suggest that rates may actually remain on hold in the UK.

To be rewarded with ten times your money for rates on hold seems untypically generous when the alternative is to chase a stock market that has already climbed 50%. Let others fret about their investment franchise risk from not being in the market, we are going to stick to where the profit opportunities seem most attractive.

**Do you come from a land down under?
Where women glow and men plunder?
Can't you hear, can't you hear the thunder?
You better run, you better take cover.**

Men at Work, Down Under (1982)

The world of Australian interest rate expectations offers perhaps even greater upside. Australia has one of the most financially leveraged private sectors in the world with private debt 238% of GDP vs. just 65% back in 1929.

Overnight rates at 3% are high by the standards of Europe, Japan and the US. But owing to its ability to sell iron ore and other commodities to the Chinese the market believes that in two years time the authorities will have to raise rates to 6%. I say, bring it on.

If on the other hand they remain at 3% then we make 5x our money. But, in the event that the China surge fails, and it dooms its local industry to a glut of overcapacity and poorly conceived infrastructure projects, the trade becomes profoundly rewarding.

Without China's heady accumulation of commodities I am sure that the Australian economy would falter. And under such straightened circumstances I could imagine that the monetary authorities might even reduce rates to British or European levels; the pay-off would be at least 25x.

I would put this trade on a par with buying \$50 crude oil puts last July. Who would have thought it possible?

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