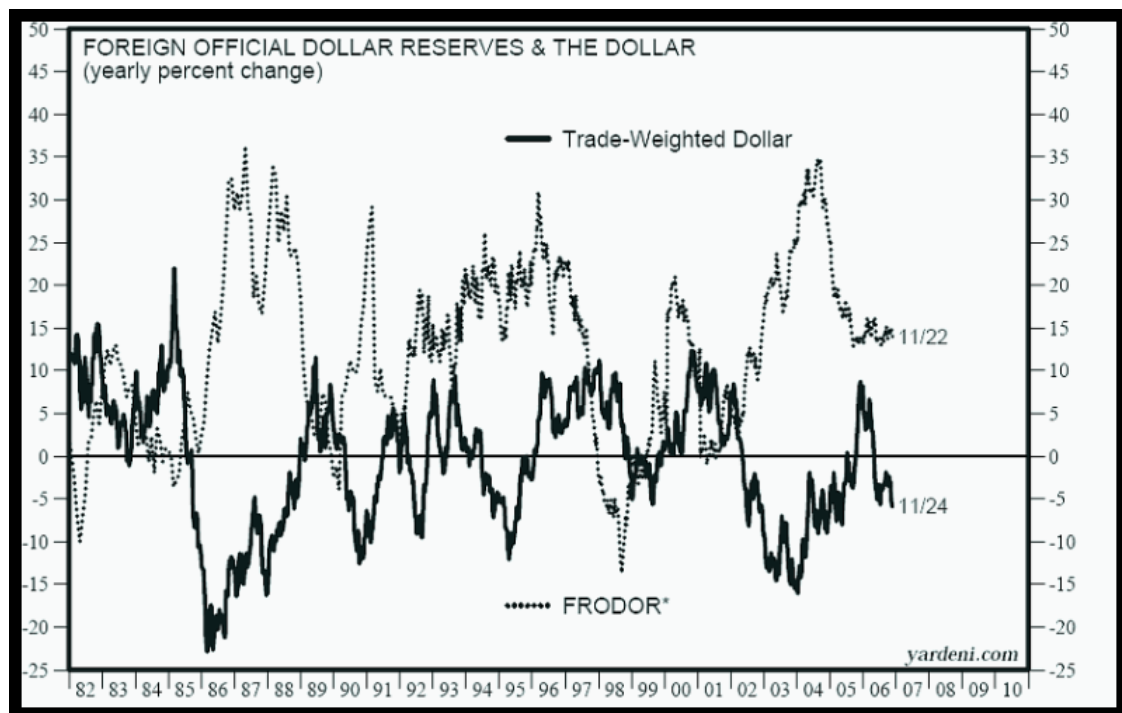


Economic and Financial Implications of Excess Liquidity!

Marc Faber

Contrary to frequently expressed views monetary conditions have not tightened. As can be seen from figure 1, Foreign Official Dollar Reserves are still growing at more than 15% per annum and International Reserves are up year-to-date by more than 18%.

Figure 1: Foreign Official Dollar Reserves – still expanding rapidly!



Source: Ed Yardeni, www.yardeni.com

Periods of tightening international liquidity occurred from 1987 to 1990, from 1996 to 1998, and from 2000 to 2002. When international liquidity, which is largely supplied by the US current account deficit, tightens, the US dollar usually also strengthens (see figure 1). Conversely, when international liquidity expands, the dollar weakens, as was in particular the case between 1985 and 1986 and between 2001 and 2006. We could therefore argue that rising international liquidity means rising asset prices but a declining dollar,

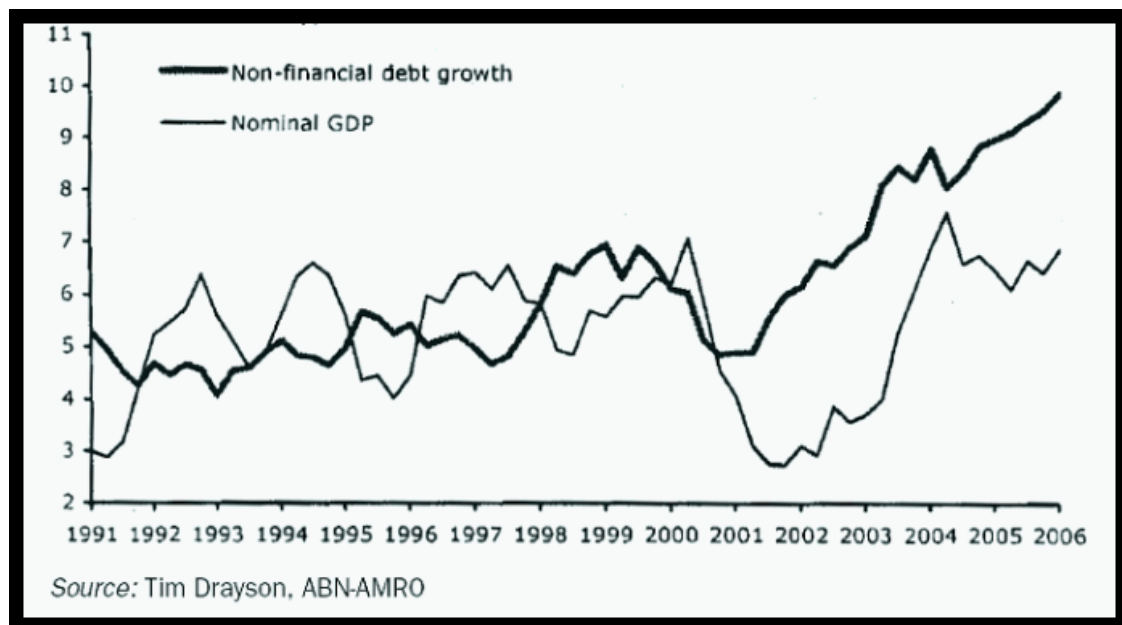
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whereas contracting international liquidity leads to a strong dollar but weak asset markets. The question, however, is what rising and declining asset prices mean for an investor. From figure 2, we can see that US debt is still growing much faster than nominal GDP. So far this excessive debt growth has led to strong asset inflation, over-consumption and an explosion of the US current account deficit from 2% of GDP in 1998 to close to 8% of GDP at present.

Figure 2: US Non- financial Debt Growth, 1991 – 2006.

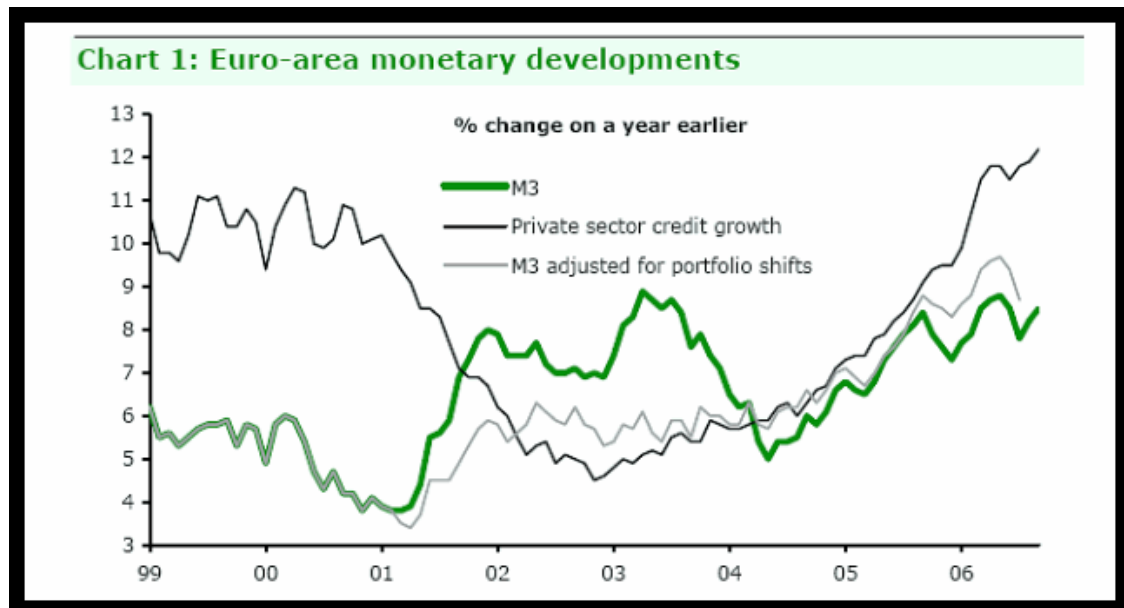


Source: ABN-AMRO

But in the Euro region private sector credit growth has been at least as strong as in the US (see figure 3). So, what does this mean? If the US Fed tightens relative to the ECB, the dollar should rally against the Euro. Conversely, if the ECB tightens relative to the Fed the Euro should continue to strengthen. Now, what is more likely to occur? US economic growth is slowing down and, therefore, Fed tightening is rather unlikely. European growth, however, is probably stronger than statistics reveal and the ECB is far more concerned

about asset inflation than the Fed. Therefore, tighter monetary policies by the ECB are very likely.

Figure 3: European Monetary Developments, 1999 - 2006



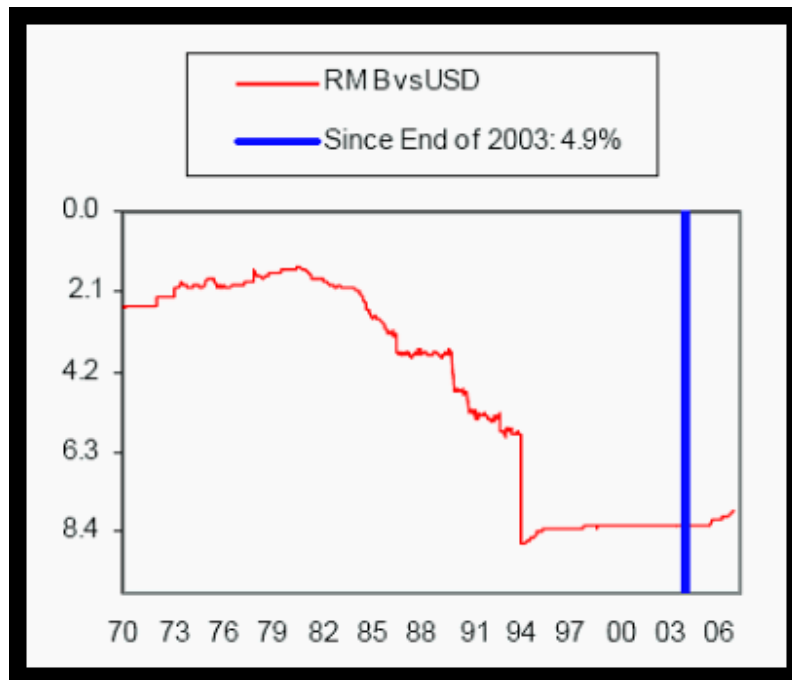
Source: ABN-AMRO

But here comes the tricky part. If the Euro continues to strengthen it is likely to slow down European and accelerate US economic growth. In such a case, the possibility of tighter US monetary policies relative to European monetary policies would have to be considered. In my opinion, this would be the case if the US dollar fell to 1.35 against the Euro. So, whereas I maintain my fundamentally negative stance toward the US dollar, I am not sure that the dollar has a huge downside risk against the Euro.

However, looking at the speed of international reserve accumulation at the hands of Asian central banks and in particular at the rise in reserves of China – now over \$1 trillion – it would seem that Asian assets would still likely out-perform US assets in the long run. When countries have current account surpluses the size of China three events can happen. Either the currency strengthens considerably or asset prices (stocks and real estate increase in

value) or both currency and asset prices increase (this was the case for Japan in the late 1980s (see figure 4))

Figure 4: Chinese RMB compared to US Dollar, 1970 – 2006

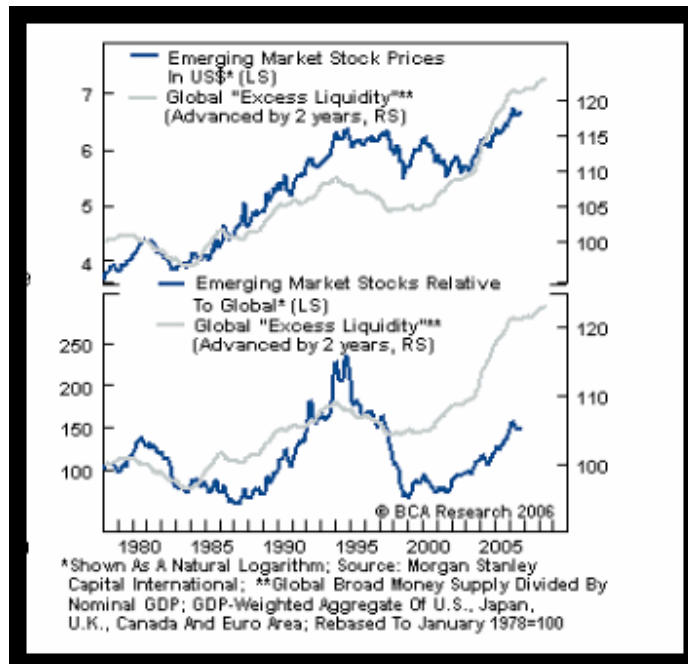


Source: Bridgewater Associates

As can be seen from figure 4, the RMB devalued massively in 1994 and was thereafter pegged to the US dollar at \$1 = RMB 8.28. However, over the last twelve months a steady appreciation of the RMB has taken place, with one dollar now buying just 7.84 RMBs. From my perspective it would not be surprising to see the RMB rising to around 6 against the dollar (see figure 4). A rise in the value of the RMB against the dollar would likely also lead to other Asian currencies strengthening against the dollar. It is of course also possible that the Bank of China will resist a further increase in the value of the RMB against the dollar. In that case I would expect the market mechanism to lift Asian asset prices relative to asset prices in the western world. From figure 5, we can actually see that, since 2001, emerging market

stocks have massively out-performed global stocks and are the prime beneficiary of “excess global liquidity”.

Figure 5: Emerging Stock Markets Relative to Global, 1978 -2006

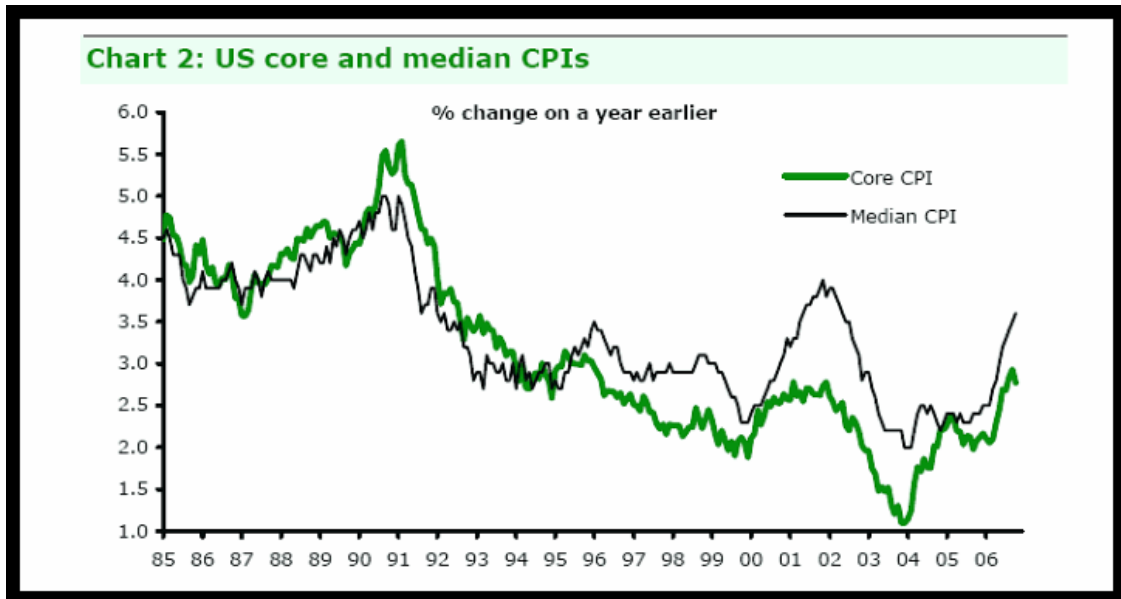


Source: The Bank Credit Analyst

Still, I am concerned about a few issues. For one, the consensus is that we are in the midst of a “Goldilocks” economy, which would not even be clouded by a soft landing in the US and that, as I have pointed out above, there is this huge excess liquidity in the system and that nothing will ever disturb this tidal wave of liquidity.

That may be the case but we should remember that some assets can also decline amidst plenty of liquidity. This happened to commodities and especially oil in the 1980s, to Japan in the 1990s, over the last 15 months to homebuilding shares, and since the end of last year to Middle Eastern stock markets and small market cap stocks in Japan. Moreover, it should be clear that the higher asset prices move up the more money is required to drive them even higher. So, to move markets higher an acceleration in the quantity of liquidity is required, which one day could lead to some serious inflationary pressures, which could drain liquidity (see figure 6).

Figure 6: US Core Inflation and Cleveland Fed Median CPI, 1985 - 2006



Source: ABN-AMRO

In this respect, I should like to point out that when “consumer price inflation” shifted to “asset inflation” in the early 1980s, nobody expected this to happen. So, we should not expect that someone will ring a bell, sometime in future, to signal a shift from asset inflation to consumer price inflation. Therefore, I consider the timing of liquidating one’s assets, sometime in future, as the most important investment decision investors will be confronted with. The key is not to have money when everybody else also has money and, therefore, drives up asset prices, but to have money when everybody is leaking his wounds and is financially in a desperate situation, as was the case following the 1997 Asian crisis. Looking at the shape of asset markets’ recent increases in value (stocks, bonds, commodities, art, “trophy” properties) and at the optimistic and complacent mood (record low volatility) among investors in all asset classes my view would be that reducing one’s assets positions between now and early January might not be a bad idea. In fact, I need to admit that my greatest worry is that I am not as

bearish as usual about asset prices rising further. As a contrarian indicator this might tell you something!

The second concern I have, and this has more to do with capitalism and our society in general, relates to the following. In *The Economics of Inflation* (University of Bocconi, 1931), Professor Bresciani-Turroni writes about the German economy that although some “windfall profits” had been derived from especially favorable circumstances before the First World War, “it must be acknowledged that the captains of German industry had some eminent qualities. The origin of their fortune was sometimes a technical discovery of great importance (e.g. Krupp, Siemens, Mannesmann); or they owed their success to having created new forms of economic organization (e.g. Emil Rathenau, the founder of A.E.G.); or they opened new routes for German commercial expansion, creating the banking organizations necessary for penetration into foreign markets, as did Georg von Siemens, the founder of Deutsche Bank. Thyssen, a great industrialist, had applied on a vast scale the principle of “vertical concentration” of firms, i.e. the combination of coal, iron and finished products. In short, the great leaders of the German economy were producers. Then, referring to the post-First World War hyperinflation period, 1919–1923, Bresciani-Turroni writes:

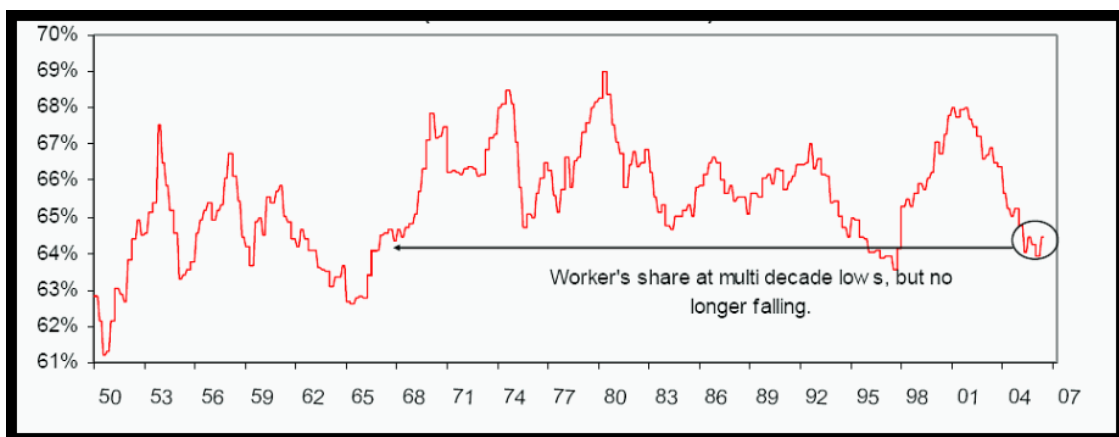
But the new men of the post-war period were not generally creators of new industries or new forms of economic organizations (the principle of “vertical concentration”, of which so much was heard after the war, had already been applied here and there in the pre-war German economy). The new men were for the most part very clever speculators, combining their knowledge of business with the strategy of the Bourse and of high finance. And, above all, their successes were intimately connected with the inflation. **In post-war Germany the spirit of speculation spread in all classes of society as a result of the inflation** (emphasis added). For the inflation made all values unstable, and obliged many of the working classes and those with small incomes to seek profits on the Bourse in order to supplement their incomes which were continually being reduced by the monetary depreciation. But even industrialists were diverted from productive work and became speculators on the Bourse; it being obvious that fortunate dealings in securities and foreign exchange could be much more profitable than constant hard work involved in trying to improve production. (Today, we have a similar situation, as more and more companies’ treasury operations mirror hedge fund strategies and frequently contribute more to earnings than the

companies' operations — editor note.) The great speculators — such as Herzfeld — were only the more refined expression of the spirit of speculation which inspired the entire population. Those who in Germany in the post-war years considerably increased their own fortunes or who became new possessors of huge fortunes, were mainly those men who understood before others the phenomenon of the inflation, and who, foreseeing the continual depreciation of the German currency, used this knowledge in all their financial operations. **A German author (whose interesting observations have helped the writing of the present chapter) justifiably writes that the new captains of the German economy “derived their power from the destructive forces of their time and became rich not with the increase of general prosperity, but with the increase in the poverty of their people,” which in a large measure was caused by the depreciation of the currency** (emphasis added). Bresciani-Turroni then showed that real wages of miners, which in the middle of 1921 were about 90% of the pre-war level, were scarcely 50–60% of the same at the end of 1922 — editor note.

Now, there are the economists who dispute the fact that wealth inequity has increased over the past 25 or so years. However, if you look at the recent sales performance of Wal-Mart and compare it to the economy of the employees of the 5 largest Wall Street firms who will receive \$36 billion in bonuses one gets the impression that wealth and income shifted from the masses to a select few. According to Paul Krugman (not my favorite economist, though he is certainly well-informed): ...”working families have seen little progress over the past 30 years. Adjusted for inflation, the income of the median family doubled between 1947 and 1973. But it rose only 22% from 1973 to 2003, largely as a result of wives’ entering the paid labor force or working longer hours, not rising wages..... But the wealthy have done very well indeed. Since 1973 the average income of the top 1% of Americans has doubled, and the income of the top 0.1% has tripled”. Moreover, some studies show that the richest 1% received about one third of the total gain in marketable wealth over the period from 1983 to 2001. The next 4% also received close to one-third of total gain and the next 15% received another quarter, so that the top quintile together accounted for 89% of total growth in wealth, while the bottom 80% accounted for 11% (I may add that the \$36 billion in bonuses of the largest five brokerage firms shared among 173,000 employees is more than 60% of Vietnam’s GDP, a country with a population of 84 million people!

Huge wealth and income inequality is undesirable from an economic point of view and also usually leads to social strife. In fact, I would not be surprised that at some point the economy of the super-rich will suffer badly whereas the economy of the masses improves its relative position because wages as a percent of GDP begin to increase or the economy of the super rich – the asset shufflers -collapses (see figure 7).

Figure 7: Worker's Share as Percent of GDP, 1950 – 2006



Source: Bridgewater Associates

Investment Observations:

The last few weeks have been characterized by a weak dollar and rising equity, bond and commodity prices. As we move into 2007, the pattern will be the same. Either the Fed finally decides to implement tight monetary policies which would strengthen the US dollar and weaken all asset prices except bonds, or the Fed continues with its expansionary bias. In that case asset prices (except bonds) will continue to rise and the dollar will continue to weaken. However, it should be understood that under easy monetary policies, dollar assets (US equities, bonds and real estate) will, as has been the case for the last few years, under-perform foreign assets and commodities. Since Mr. Bernanke was appointed Fed chairman the S&P 500 is up in dollars by 14.6% but only by 7% in Euro terms. Over the same

time frame (November 1, 2005 to November 27, 2006) gold is up 40%, silver 80%, and copper 68%. Year to date, the S&P is up 11% in dollars but only up 0.2% in Euros and of course down against gold and silver. The worst investments were US dollar cash and bonds. both of which declined in value in Euro terms, and in gold terms.

As indicated above, from a contrary point of view, reducing exposure to asset markets over the period directly ahead will likely prove to be the correct strategy. If buying during panics makes sense, selling during euphoric buying binges might also be the right strategy. As Bridgewater Associates noted, “the irony is that volatility is at its lowest when global imbalances are at their largest”.

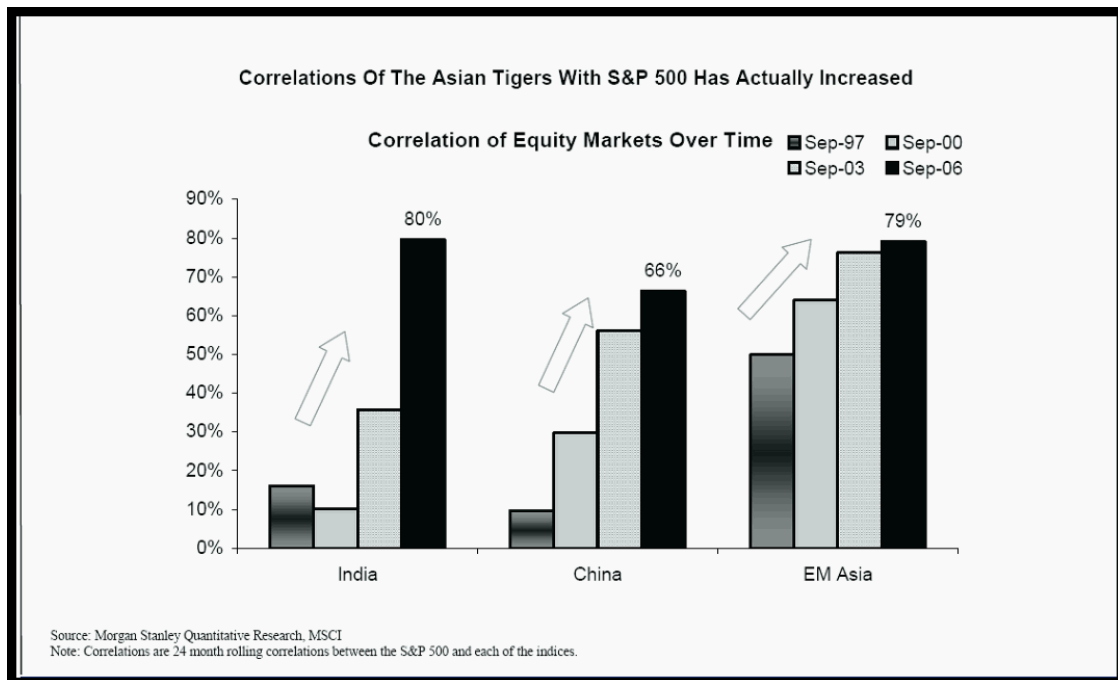
Stock markets may shortly top out amidst rapid group rotation taking place. Because of the Euro strength, European markets may top out first. Also, about 70% of financial institutions are now positive about high tech stocks. My inclination would be for equity investors to shift out of high tech shares back into energy (oil, coal, drilling companies) and mining shares. As can be seen from figure 8, the XOI Oil Index has positively diverged from oil prices.

Figure 8: XOI Index compared to Crude Oil Prices

Source: Bob Hoyer, ChartWorks and Ross Clark

I am mentioning this shift back into energy shares because, a few months ago, we felt that sentiment toward high tech shares was overly negative. The opposite seems to be now the case. Moreover, short positions in high tech shares have been reduced significantly.

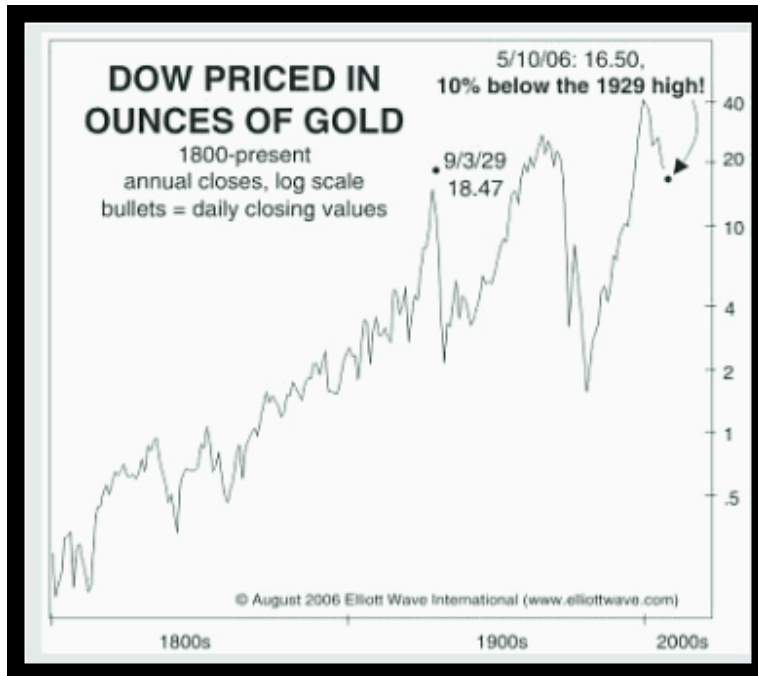
For investors who wish or need to have an equity exposure I suggest to continue to over-weight foreign markets, especially the Asian stock markets (Malaysia and Taiwan) and to significantly underweight US assets. What investors should, however, clearly understand is that, since 2002, all asset markets have risen in tandem and have become very closely correlated (see figure 9). So, when for whatever reason liquidity shrinks, all asset markets could be vulnerable to massive liquidation! (Certainly liquidity will evaporate when markets sell off – but what will be the catalyst?)

Figure 9: Correlations of Asian Tiger Markets with S&P 500

Source: Morgan Stanley

The investment, which is least correlated to asset markets would appear to be a diversified portfolio of cash, farm land, and precious metals. In particular precious metals could benefit from financial turmoil! As Robert Prechter recently showed, gold will at least maintain its purchasing power, both in a period of high inflation and also if asset markets implode (see figure 10).

Figure 10: Dow Jones (ex dividends) Priced in Gold, 1800 - 2006



Source: Robert Prechter, www.elliottwave.com

We wish all our readers a Merry Christmas and a Happy New Year!

Marc Faber