What a Mess!

Marc Faber

A friend of ours, Jared Dillian, who works for Lehman Brothers, writes every day a short and witty comment about markets (jdillian@bloomberg.net). Recently he had this to say (abbreviated):
"When Kim Basinger asks Mickey Bourke what he does for a living in 9 ½ weeks, he says, 'I buy and I sell money'. Matt MacCleod, is an FX sales trader here, also buys and sells money. McCleod is a good friend of mine and helpful to me because he does not trade on quant or systems, but on anecdote. And when he has a good anecdote he shares it with everybody. Read below:

*True story. I am in Dunkin Donuts yesterday morning on 28/Madison. 5 customers in the store: myself, a British couple and another Euro couple. The British guy orders some coffee and a bagel, pulls a $20 out of his wallet, looks at his wife and says "I keep thinking this is equivalent of a GBP20 note... but really, it's pretty useless (and chuckles)." His wife looks at him, dead serious, and says "well 20 dollars in the US buys a lot more than 10 pounds in London." He nodded in agreement - as do I. Add to it 10+% off with a British passport at many dept stores and it's no wonder sales were up 4-9% this weekend.

Back in the summer of 1988 I was glomming around northern Virginia. My best friend worked at Mount Vernon Manor, George Washington's solid gold house, making and selling hamburgers. He explained to me that there had been a couple of instances of Japanese tourists trying to pay for a $1 orange juice with a $100 bill (and not looking for $99 in change).
What we are talking about here is purchasing power parity, or the theory that currencies should be valued so that goods are priced equivalently in country A and country B. As we know, this is not always the case. Some goods are consistently miss-priced (haircuts) because they are impossible to arbitrage, and the price of which are generally more correlated to incomes. When purchasing power gets out of whack, as is currently happening in the US, it makes the news.

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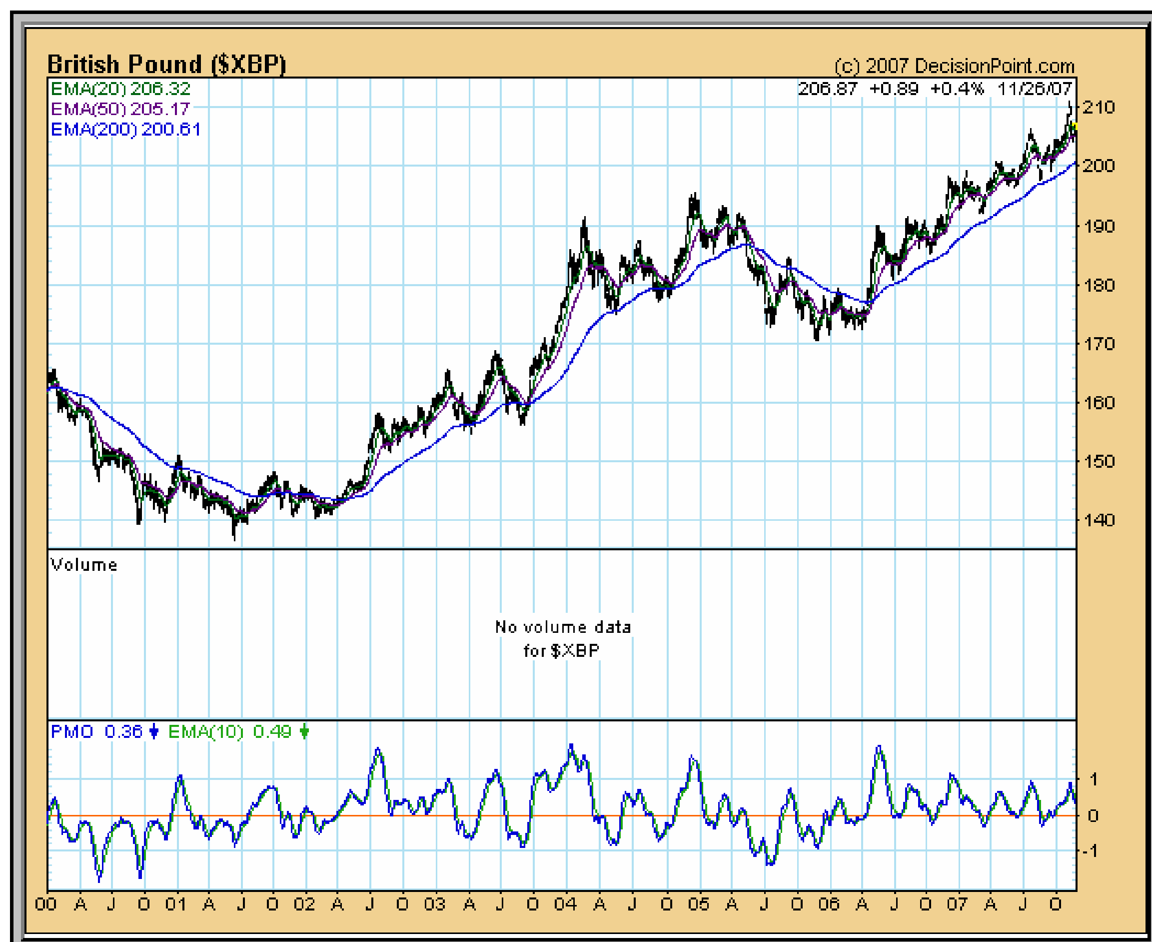
The question is whether PPP disruptions are a reliable trading indicator. After all, a basket of goods priced in dollars can stay undervalued relative to a basket of goods in Sterling for a long time. But if you are like me and Mr. MacCleod and you pay attention to anecdotes such as these, then maybe your interest is piqued. When foreigners are going around and comically lifting worthless US assets, you know the end is near. We aren't to that stage yet; right now we have some opportunistic tourists buying luggage, T-shirts, and the occasional apartment. The big trade has yet to go up. We are not close to the end of the dollar dirt-nap. But probably it is the beginning of the end."

Jared makes some interesting observations and confirms what I have experienced over the years when traveling around. Sure, the Pound Sterling is "expensive" compared to the US dollar (see Figure 1).

Figure 1: British Pound - An Overvalued Currency?



Source: www.decisionpoint.com

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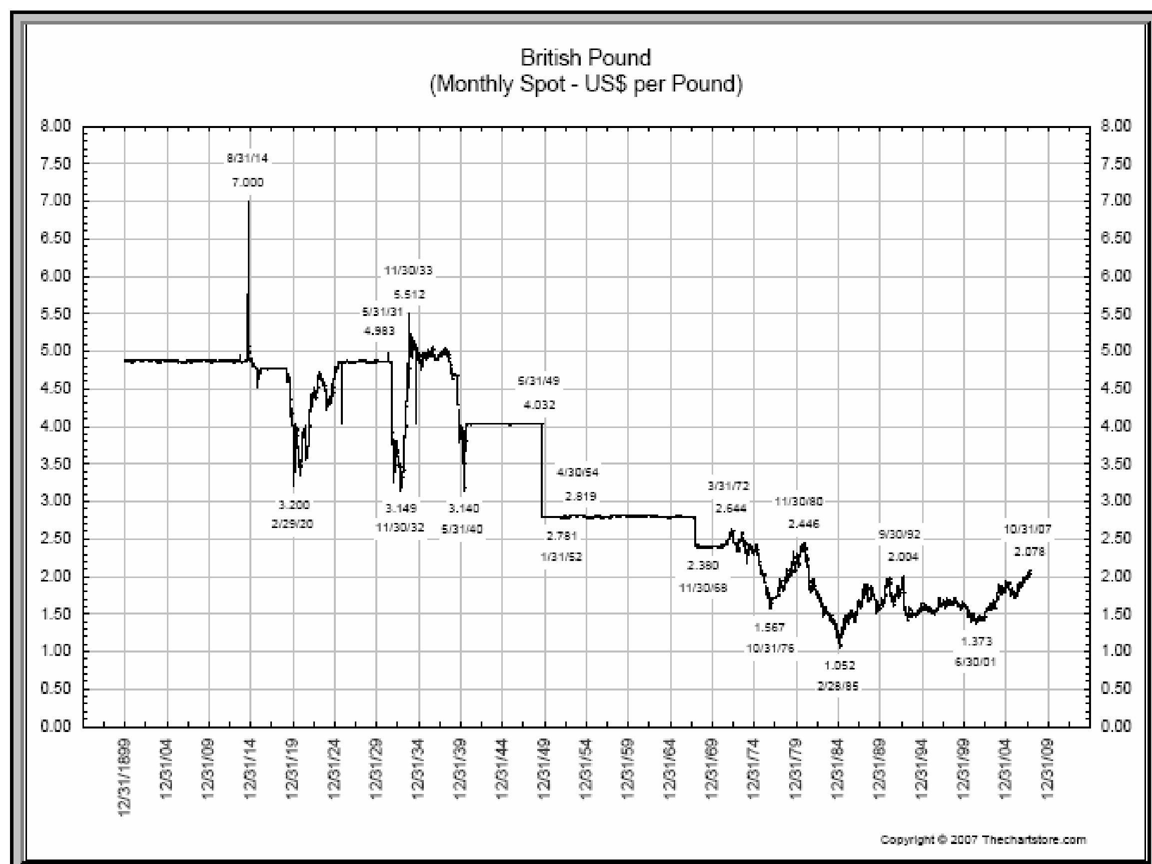
However, there are many factors other than currency movements that can lead to a rebalancing of purchasing power parities. Let me explain. When I arrived in 1973 in Hong Kong, I frequently asked when people quoted me prices if they meant US dollars or Hong Kong dollars. Prices were simply so inexpensive. At the time you could take a fairly long taxi drive for less than one US dollar. But what happened thereafter was not that the Hong Kong dollar appreciated against the US dollar but that inflation in Hong Kong exceeded US inflation for so long that in the end the Hong Kong dollar was devalued against the US dollar by more than 40%. I may add that while the British Pound may have overshot in the short term against the US dollar, from a longer term perspective the downtrend of the British Pound compared to the US dollar, which was in existence for much of the last century, seems to have ended (see Figure 2).

Figure 2: British Pound 1899 – 2007 - Has a Long Term Down Trend Come to an End?



Source: Ron Griess, www.Thechartstore.com

(As an aside, I think it is always important to look at charts from both a short and long term perspective in order to draw conclusions). Also,

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whereas I tend to agree that the US dollar is inexpensive compared to the Euro, I was taken to task by a German when making this observation at a conference. He maintained that in Germany – outside the very large cities – the price level was lower than in the US. When adjustments for quality are made I suppose that this is quite true. In fact, rather than to try to pick the bottom of the US dollar versus the Euro a better and less risky trade could be to buy the Japanese Yen against the British Pound or the Euro (see Figure 3)

Figure 3: Japanese Yen versus Euro: A Major Low?

Source: www.decisionpoint.com

Still, there are now some forces which should become US dollar supportive. First of all, the seasonal weakness of the US dollar should end around the turn of the year (see Figure 4).

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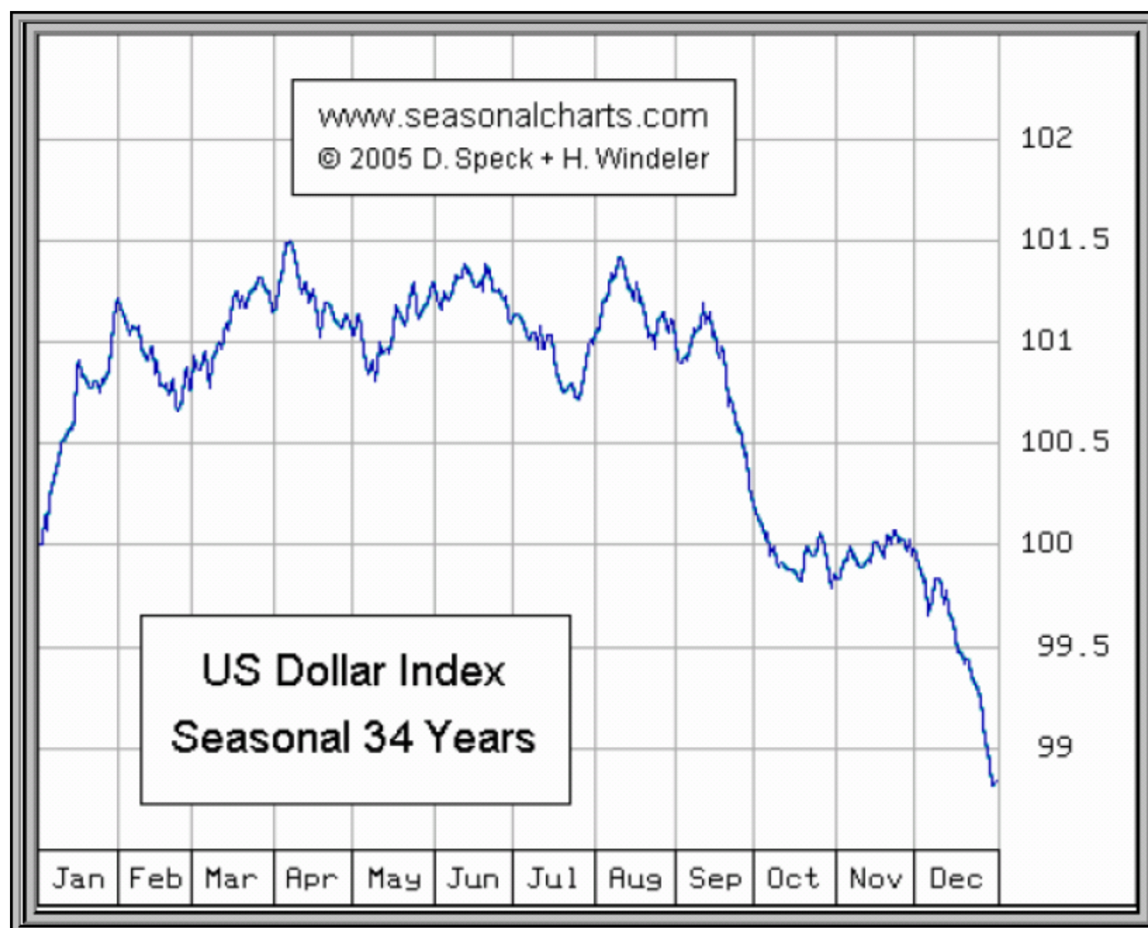
Figure 4: Seasonal Pattern of the US Dollar Dollar



www.seasonalcharts.com

Also, as we have pointed out before, a relative tightening of global liquidity is now underway because the US trade and current account deficits have begun to contract (see Figure 5). There is still plenty of liquidity floating around the world courtesy of central banks but the rate of growth is no longer accelerating the way it was between 1998 and 2006. Please note on Figure 5 that the US current account deficit began to expand in 1998 but it took until 2001 for the market to react and sink the US dollar. Therefore, while at some point US dollar strength should be expected, a meaningful time lag could occur between an improvement in the US current account deficit and US dollar strength. So, as a trading and market timing tool the US current account deficit would seem to be a poor indicator. Where the US current account deficit is a more reliable indictor is with respect to international liquidity, which we may define as global monetary base and international reserves. When global liquidity

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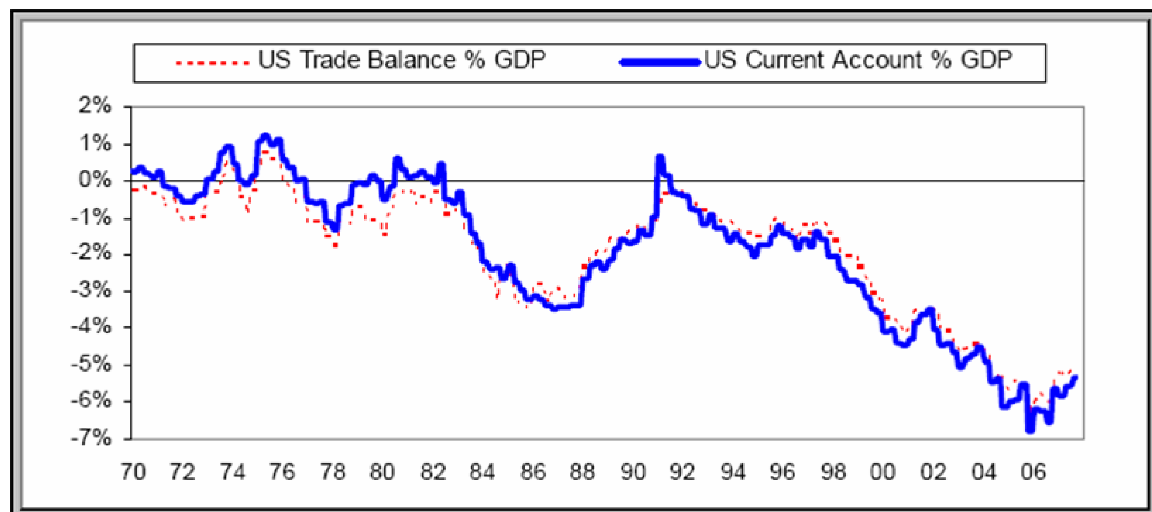
expands at an accelerating rate, the global economy and asset prices tend to perform well. However, when the growth rate in global liquidity slows down or even declines, problems follow for both asset markets and the economy.

Figure 5: Shrinking US Trade and Current Account Deficits lead to a Relative Tightening of Global Monetary Conditions!



Source: Bridgewater Associates

To the US dollar "perma-bulls" - who having been totally wrong for the last six years but now find new ammunition in the shrinking current account deficit to support their dollar bull case - I also need to point out that there were periods – such as between 1985 and 1991 - during which the dollar tanked while at the same time the current account deficit shrank! This leads me to another point about the world of investments. To make generalizations about what happens to markets when certain events like wars, favorable earnings announcements, tax and interest rate cuts etc. occur is dangerous because it all depends on where markets stood before these events took place. The reason why the dollar fell after 1985 despite an improvement in the current account deficit was that it had rallied between 1980 and 1985 and that, in 1985, the dollar had become significantly over-valued against major foreign currencies. This is now certainly not the case since the dollar has declined for six years against the Euro, but what I am driving at is that the investment community still believes that the Fed, by cutting interest rates, can support the housing and stock market. But, as Jeremy Grantham of GMO pointed out, median US home prices compared to median incomes rose between 1998 and

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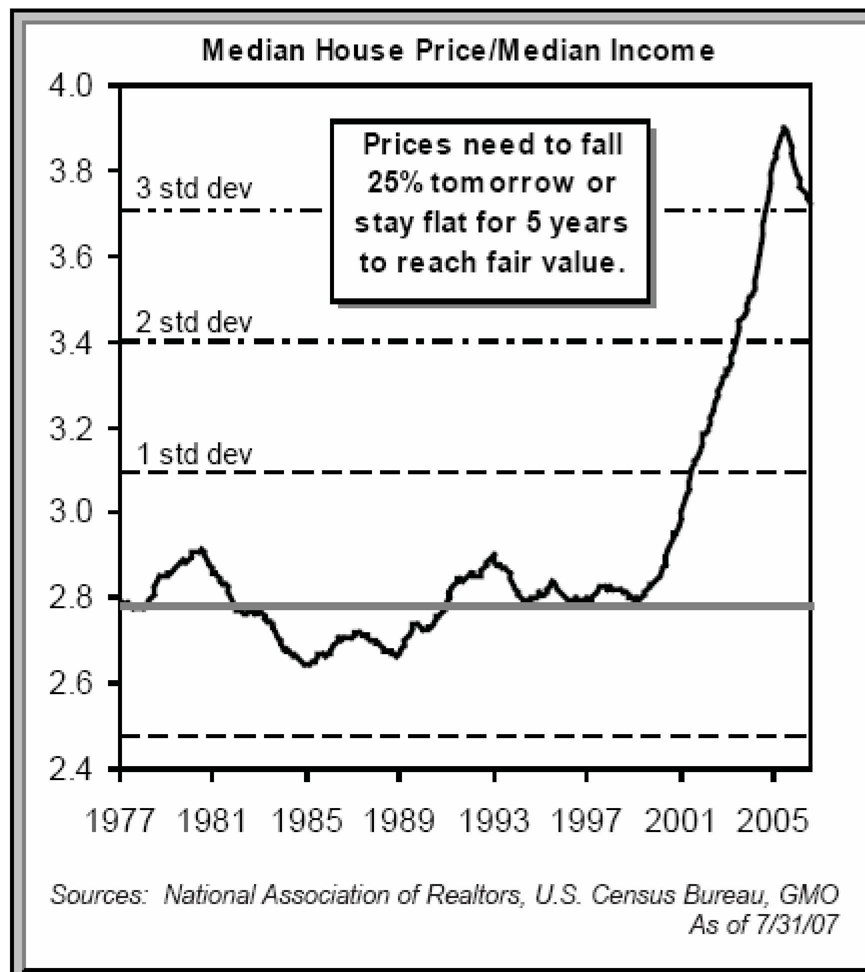
2006 so far above the trend that prices could continue to decline even as the Federal Reserve cuts interest rates (see Figure 6).

Figure 6: Median House Prices Compared to Median Personal Income, 1977 – 2005



Source: Jeremy Grantham, GMO

Also to consider is that unless the Fed buys up mortgages and CDOs it has little control about the pricing of non-government debt (I also doubt that it has much control over the pricing of long term government debt). So, the Fed can cut interest rates, but if credit spreads are widening – as is now the case – rate cuts bring little relief to asset markets and specifically to the housing market because spreads on mortgages are widening (see Figure 7).

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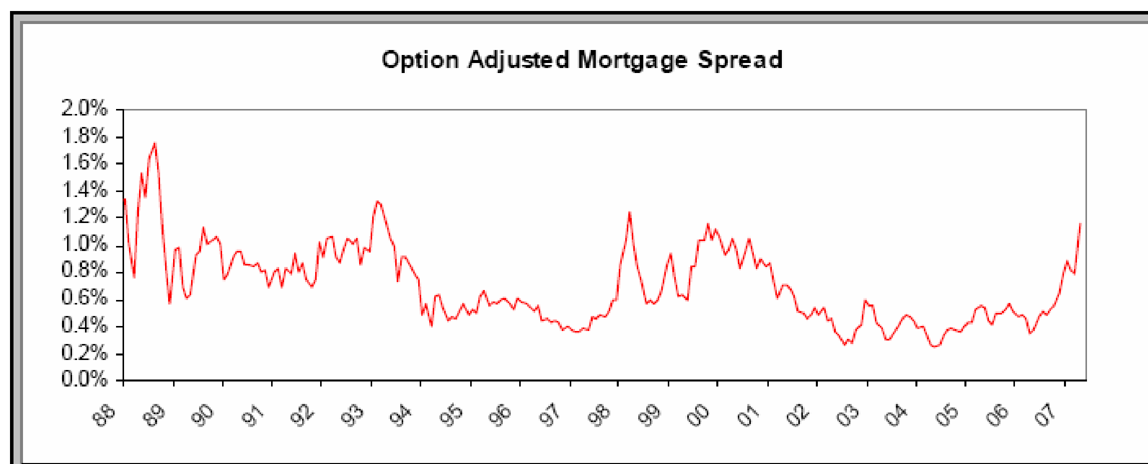
Figure 7: Mortgage Rates Spreads, 2003 – 2008



Source: Bridgewater Associates

Concerning the Fed and the government buying up mortgages, another point should be considered. When the sub-prime mess emerged in July of this year, Senator Charles Schumer initially responded to his Wall Street campaign contributors by arguing for rate cuts and for Fannie Mae and Freddie Mac to expand their balance sheets in order to bail out the Street. But recently Senator Schumer seems to have changed his stance by urging regulators to examine potential risks posed by a sharp increase in lending by the Federal Home Loan Bank of Atlanta to Countrywide Financial Corp, the nations largest mortgage lender. Schumer: "I am concerned that the loans being pledged by Countrywide to secure these advances (borrowings) may pose a risk to the safety and soundness of the FHLB system as a whole" (maybe some short sellers are also supporting him…).

I would also be concerned since Countrywide's borrowings from the Atlanta FHLB totaled as of September 30, 2007 $51.1 billion, up 77% from three months earlier and accounted for over a quarter of the Atlanta FHLB's total assets of $191 billion! Moreover, I am also concerned that, as Noel Roubini notes, "the $51.1 billion that Countrywide borrowed from the Federal Home Loan Bank system (specifically the Federal Home Loan Bank of Atlanta) has finally revealed the little dirty secret …. that Countrywide, the largest US mortgage lender, has received a massive stealth public bailout that has put at severe risk taxpayers' money. Here is Countrywide - the premier poster child financial institution of the reckless and predatory lending practices of the last few years – getting in severe financial trouble because of its rotten lending practice in subprime, near-

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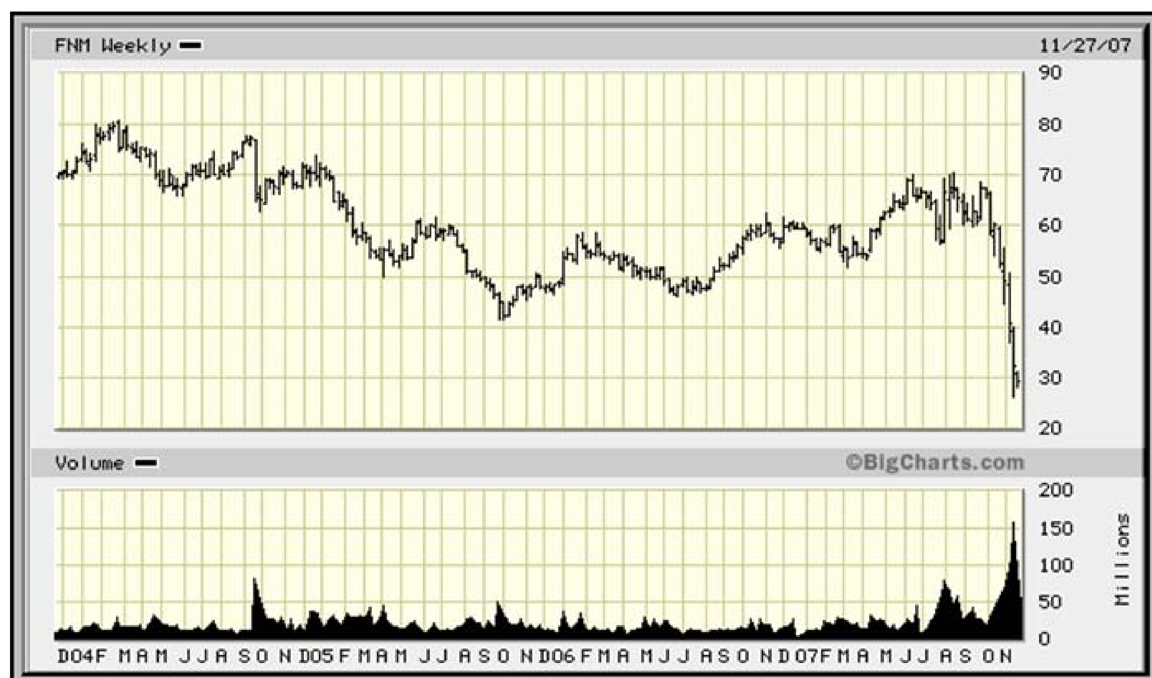
prime and prime mortgages – and whose CEO Mozilo is under SEC investigation for potentially illegal activities – now receiving a massive $51.1 billion of public bailout money with little official supervision of such lending."

Finally, the idea of Senator Schumer to have the GSEs Fannie Mae and Freddie Mac to expand their balance sheets was not only absurd to start with but is now also impractical – given the collapse in their share prices - unless they manage to raise new capital (see Figure 8). I may add that the balance sheets of the GSEs are already hugely leveraged: shareholder's equity amounts to just $49 billion while their balance sheet has increased from $1.5 trillion in 1997 to $4.5 trillion at present! Moreover, should default rates increase far more, the GSEs could actually go bankrupt or require a government bailout because both Fannie Mae and Freddie Mac have guaranteed several trillion dollars worth of Mortgage Backed Securities!

Figure 8: Fannie Mae, 2004 - 2007



www.bigcharts.com

In essence, what I wish to express is simply that bailing out some rotten financial institutions (I guess all of them are) with monetary measures is far from certain to succeed and - most importantly – such bailouts may lead down the road to a total collapse of the economic and social system.

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I was intrigued by a comment John Hussman of Hussmann Investment Management recently made. Hussmann: "as Jim Stack of Investech recently noted, a market drop of even the recent -7.1% following a third discount rate cut has happened only 3 times in the past 80 years: February 1930, July 1982, and March 2001. In each case, the economy was already in recession (or worse). 'Those are not the kind of odds that make one feel comfortable in today's uncharted waters.' I should add that the 1982 instance was different than the others (in that it was followed by very strong market returns) This holds because the S&P 500 price/peak earnings multiple in July 1982 was already less than 7. These periods are also interesting for another reason: if you look at what happened to S&P 500 earnings over the following year, you'll find that earnings plunged in each instance: 1930: -39.4%, 1982: -15.9%, 2001: -49.8%."

At about the same time I stumbled about Hussmann's comments most US companies had already reported their third quarter profits. Now, surprise, surprise (certainly for the goldilocks crowd and the high priests of the "permanently higher corporate profit margin" cult), operating EPS for S&P 500 companies fell y-o-y by 8.5% (see Figure 9). According to David Rosenberg, on a year-on-year basis this was the worst showing since the fourth quarter of 2001. **"On a sequential quarter-on-quarter basis, earnings dropped 12.4% (not annualized), the worst third quarter result since 1989 – and this is operating, which strips out write-offs and reflects current economic related activity."**

Moreover, according to Rosenberg, what was more shocking were the "reported" numbers, which unlike the operating earnings do not strip out the charge-offs incurred: **"here the results were even more abysmal as reported EPS plunged 28% year-on-year, which was the worst print since the fourth quarter of 2002. On a sequential basis, reported earnings plunged 29% quarter-on-quarter (not annualized), which is a 75% plunge when expressed at an annual rate, and again, the worst sequential result since the fourth quarter of 2002**. The 75% annualized slide in reported profits puts this past quarter on par with the slide we saw during the Latin America banking crisis of the early 1980s and the S&L crisis of the early 1990s."

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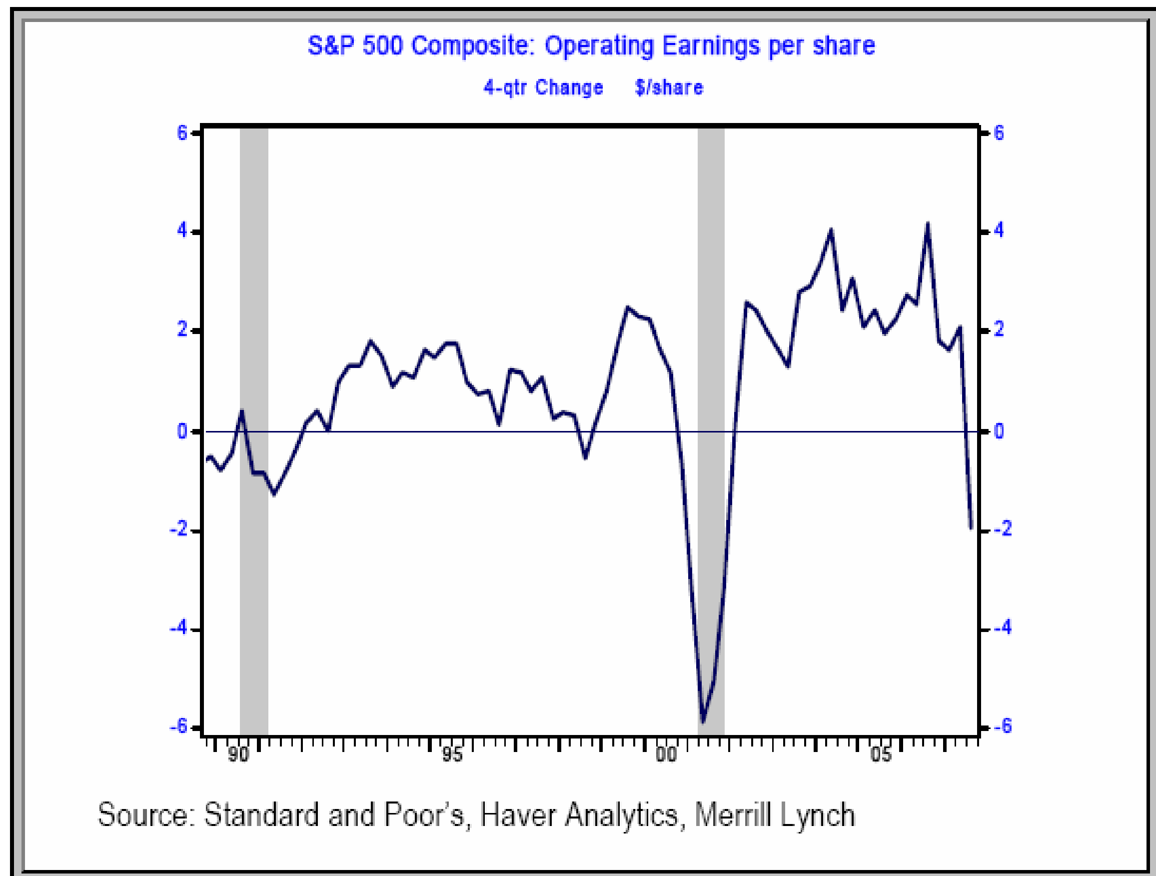
Figure 9: S&P 500 EPS: Down 8.5% Year-on-Year!



Source: David Rosenberg, Merrill Lynch

Naturally, most Wall Street strategists will contend that S&P 500 earnings will rebound shortly and increase by about 8% next year. However, precisely because of these optimistic expectations I believe that the stock market could be in for a nasty surprise should corporate profits not recover but continue to decline. Falling corporate profits could come about because of a simultaneous combination of rising cost pressures and a weakening economy, which would reduce revenues and squeeze margins. If we look at Figure 10, we can discern **two major trends** in US companies' after tax profit margins: **A margin contraction during the inflationary sixties and seventies** and a huge **margin expansion during the "disinflationary" period, which lasted from about 1980 until very recently.**

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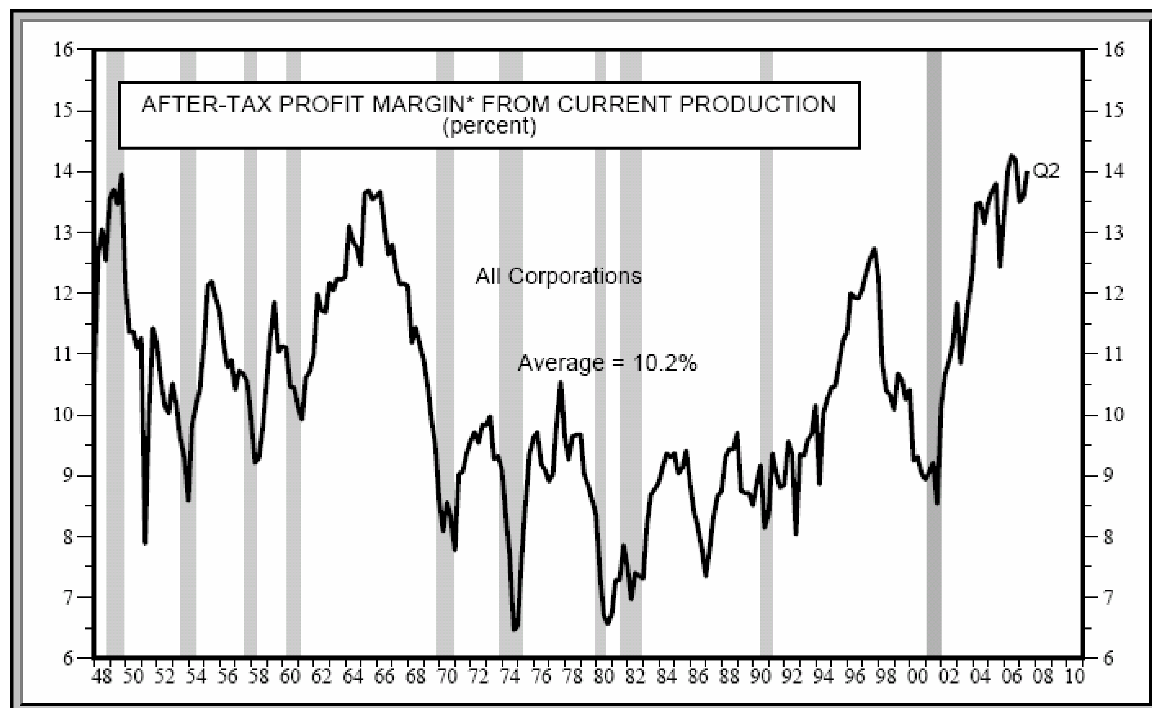
Figure 10: US After-Tax Profit Margins, 1948 – 2007



Source: Ed Yardeni, www.yardeni.com

Since both commodity prices and interest rates peaked out in 1980/81 it is safe to assume that the principal cause for the margin expansion in the 1980s and 1990s were meaningful declines in interest rates and commodity prices. However, in the current environment where cost pressures are becoming more common because of rising commodity prices, while at a time when revenue growth is slowing down, corporate profits are likely to disappoint over the next twelve months or so and put pressure on equity prices.

As of late November, stock markets around the world became very oversold. With the prospect of the money-printing Fed cutting interest rates further and now also with other central banks likely to follow the Fed, stock markets have begun to rebound. The rebound is likely to last until around the turn of the year whereby new highs will most likely not be achieved. Thereafter, stocks should resume their downtrend as it will become evident even to the diehard optimists that the economy is already in recession and that corporate profits will contract further. Therefore, we would use further strength in equity markets as a selling opportunity (for the S&P selling is recommended on a rebound to around 1500).

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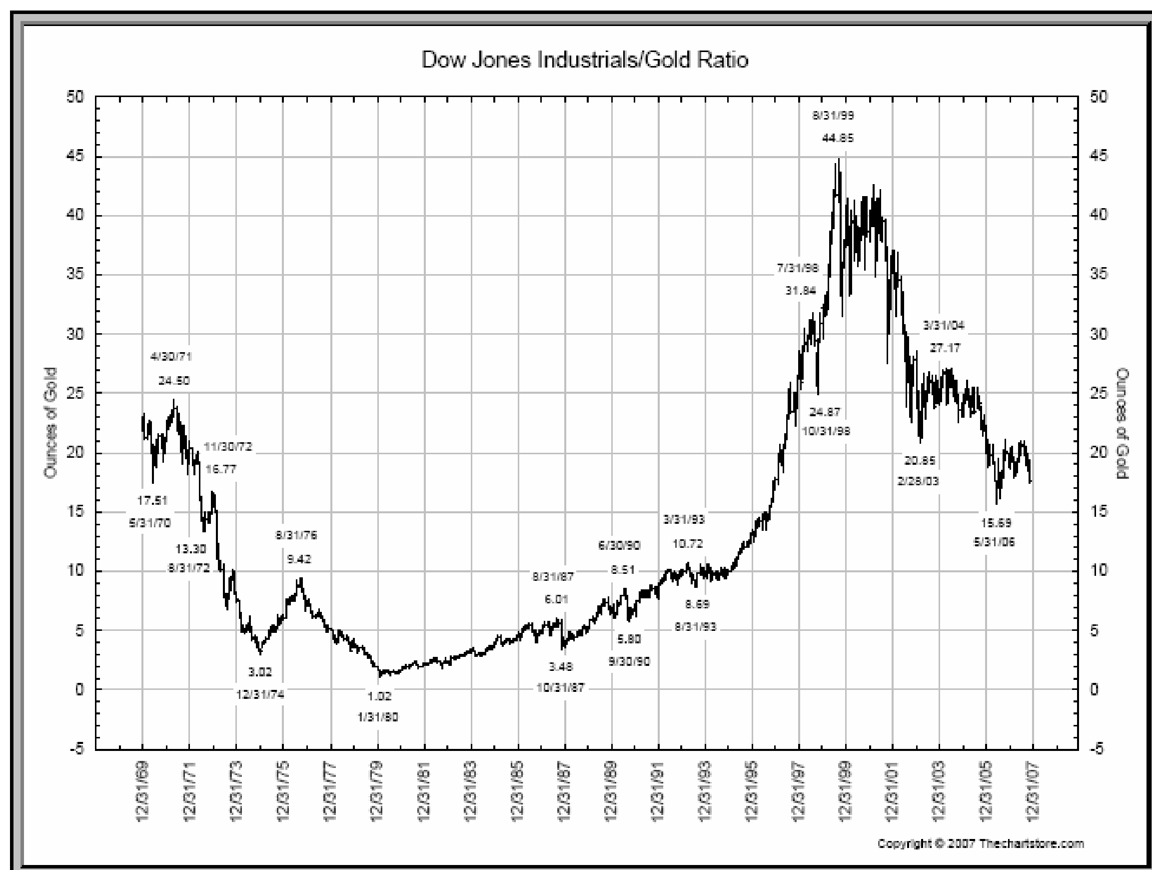
On balance, conditions for a dollar rally have improved and a shift from Euros into dollars or a long US dollar position versus the Euro or the British Pound is recommended as an intermediate trade.

As mentioned before the easier trade may be to buy the Yen against the British Pound or against the Euro (see Figure 3).

I am cautious about industrial commodity prices, which could come under pressure as global liquidity growth and the global economy slows down. And while I still think that gold will outperform equities in the years to come I believe that a more meaningful correction in the price of gold is now underway (see Figure 11).

Figure 11: Dow Industrial to Gold ratio, 1969 - 2007



Source: Ron Griess, www.Thechartstore.com

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