Contracting Global Liquidity

Marc Faber

Important notice to Subscribers:
Since I shall shortly travel to Syria, the next report will be published around September 8. Hence, this interim report. No emails will be answered until September 10.

I constantly get emails asking me whether a reader should buy ABC or XYZ today, tomorrow or next week. Lately, this has been particularly the case concerning gold (see Figure 1).

Figure 1: Gold, 2004 - 2008

Source: www.decisionpoint.com

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In this respect I should like to make a few observations about subscribers' email requests. It is physically simply not possible to answer all emails I receive although I read them all with interest. Moreover, I cannot be the personal financial planner and advisor of each of my readers – especially not since I do not know each person's individual financial position. Whether to buy gold today, tomorrow, next week or next month will depend very much on a person's financial objectives, risk profile, cash flow and his dependability, profession, age, existing asset allocation, time horizon, etc. Let me illustrate this point: To a person who has all his assets in US dollar cash (and no other holdings) I would suggest to start accumulating gold from here on down to possibly $ 600. I am not necessarily forecasting gold to drop to $600, for reasons I shall outline below it could decline to that level. However, if a person has already 99% of his assets in gold (and no other assets at all) and has no cash flow then I would not recommend to increase his position right now because the gold chart looks truly horrible since the price broke down below important support levels at around $850 (see Figure 1). If someone is a trader, gold may have some short term appeal right now because it is becoming oversold. But what is the immediate up-side potential? Heavy resistance would seem to exist between $850 and $900 while the downside risk is at least as large as the up-side potential. So, from my perspective it is not a particularly attractive trade. But I hope my readers understand that to provide each reader with a personal financial advice is simply not possible in absence of knowing each person's particular financial conditions etc. All I can say is that of my assets, which are say 100, I have about 5 in equities, 8 in gold, 8 in real estate and related investments and the rest is split between US and Euro fixed interest securities. However, have to stress that my cash flow (income) is to some extend dependent on the performance of equities since I receive some performance fees when stocks appreciate. As a result, my indirect exposure to equities is higher than is suggested by the asset allocation figures I listed above. From my fixed interest securities and from my business I have a relatively high cash flow and, therefore, I am a happy holder of gold and a buyer on the way down (in fact, irrespective of the price I buy every month some) for the following reasons. I am not a great believer in insurance policies but since I think that sooner or later the entire financial system will blow up I want to make sure that whereas my assets, which are on deposit and could become worthless through default, I shall still be left with some assets that are mine (physical gold in a safe deposit box – not in the US). I should like to emphasize that this is also a point which speaks for owning some stocks.

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Let us assume the financial system blows up. Large deposits could become worthless overnight. But if you own shares of companies – even though they may decline in value – you will still own these shares since they are a certificate of an ownership and not liabilities of someone else. So, no matter how negative a stance one might have toward equities, at this point the ownership of some solid companies might be more desirable than being a creditor in a financial system that may not be able to pay at some point in the future.

Also, I consider gold as a hedge against future renewed US dollar weakness (see also below). Finally, I maintain the view that gold will over the next few years outperform US equities and bonds as it has done already since 2000 (see Figure 2).

Figure 2: How Many Ounces of Gold it takes to buy One Dow Jones!

Source: www.decisionpoint.com

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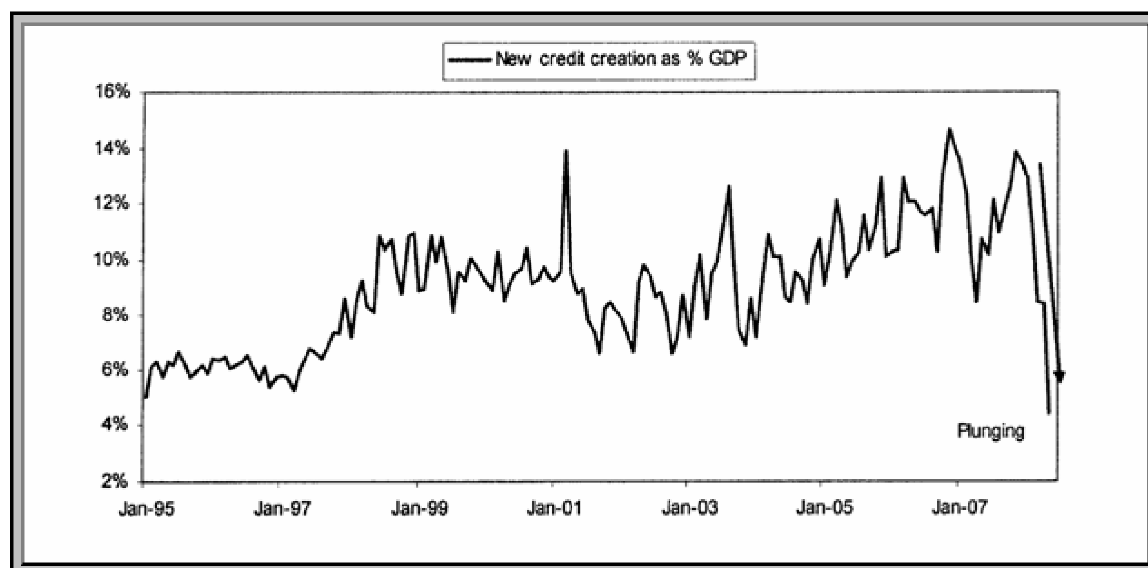
A recurring theme in this monthly commentary and in the more detailed Gloom Boom & Doom Report has been that we are in the midst of a significant liquidity contraction as a result of slower debt growth (see Figure 3).

Figure 3: Unprecedented Slowdown in US Credit Growth



Source: Bridgewater Associates

The slowdown in credit growth depresses the US housing market, the stock market and increasingly commercial property prices and leads to far weaker consumption. Official statistics still maintain that consumption is growing but if inflation was properly accounted for it would show a pronounced decline in **real terms.** Don't forget that lending standards are now tightening in earnest for both individuals and for commercial property lending (see Figure 4 and Figure 5). In turn, tighter lending standards hurt personal consumption and lead to a contracting US trade deficit as a result of lower demand for imported goods and also oil (see Figure 6). Moreover, lower imports have negative implications for Asian economic growth rates.

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Figure 4: Tightening Standards in the Housing Market

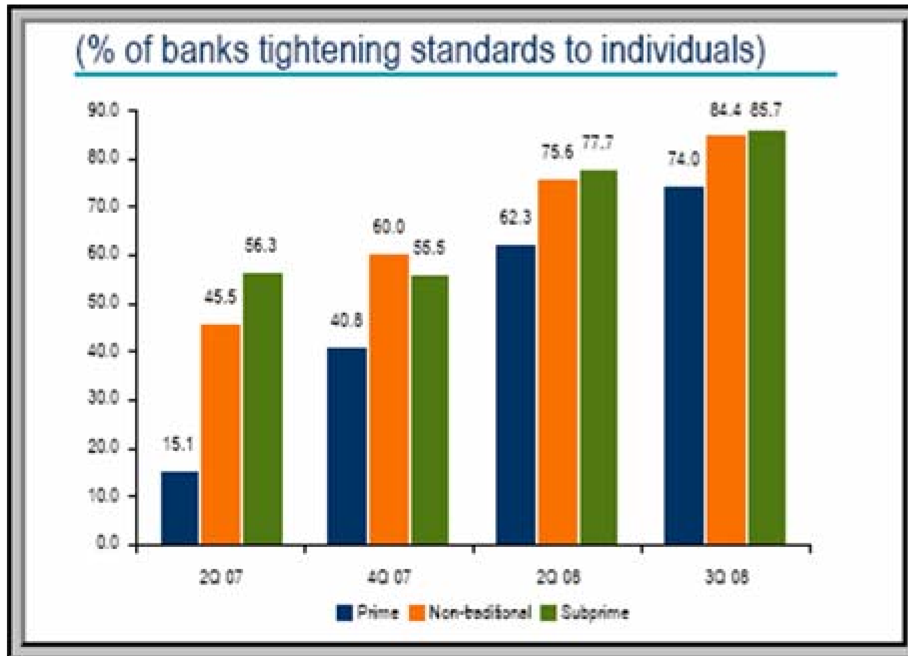
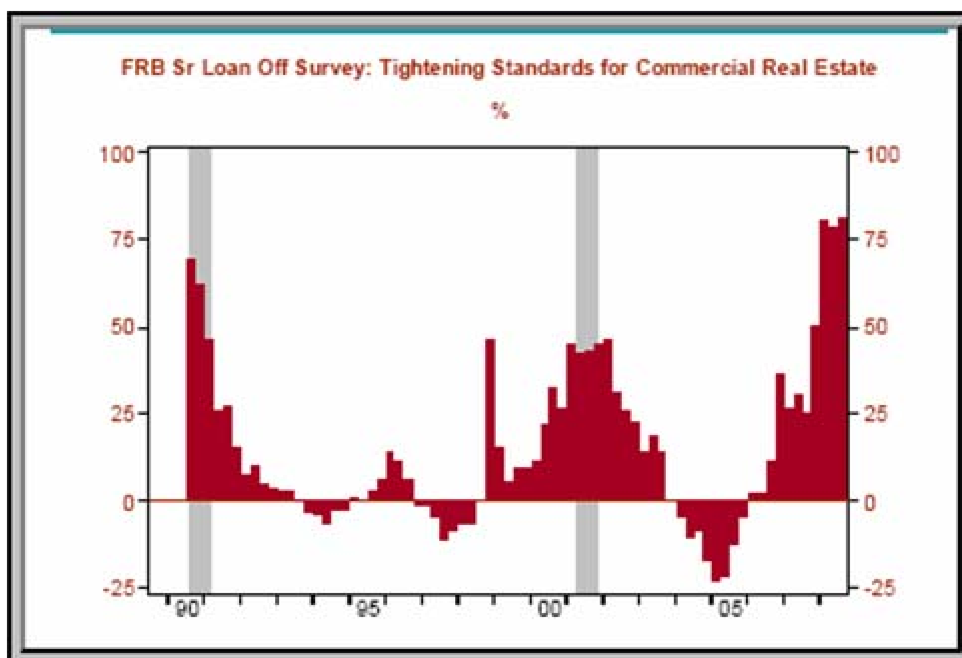


Figure 5: Tightening Standards for Commercial Real Estate



Source: David Rosenberg, Merrill Lynch

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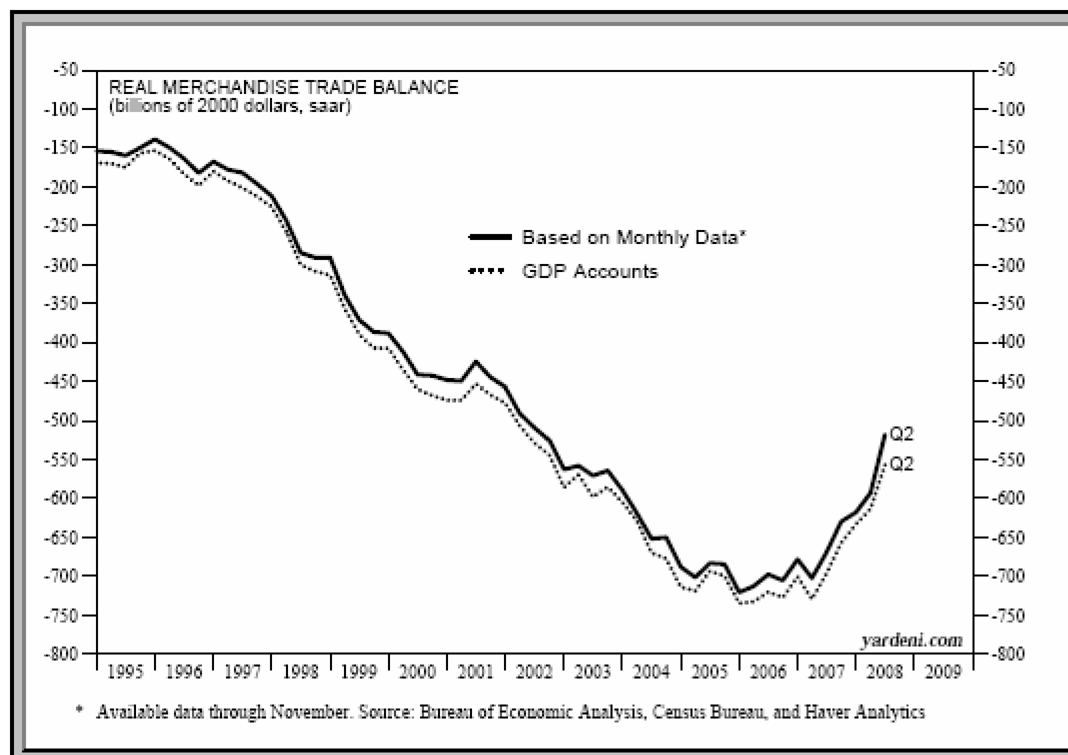
In turn, slower Asian economic growth amidst high inflation depresses the domestic demand in the Asian region, which then leads to reduced demand for commodities.

Figure 6: US Trade Deficit is now Contracting!



Source: Ed Yardeni, www.yardeni.com

In addition, a declining trade deficit leads to a decline in the current account deficit and a **relative tightening of global liquidity** as Foreign Official Dollar Reserve (FRODOR) growth slows down. Since FRODOR growth is inversely correlated with the USD and correlates over time with the movement of gold prices, any contraction in FRODOR growth would be USD supportive and negative for commodities and gold (see Figure 7 and Figure 8).

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Figure 7: Inverse Correlation between FRODOR Growth and USD

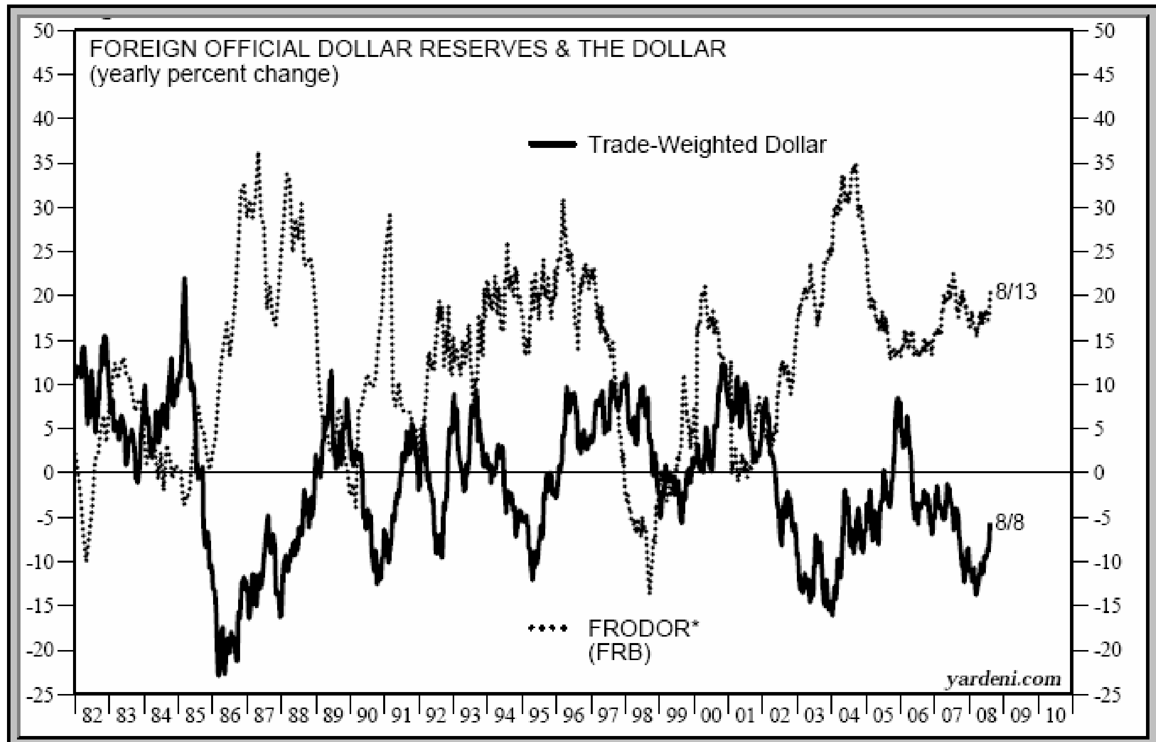
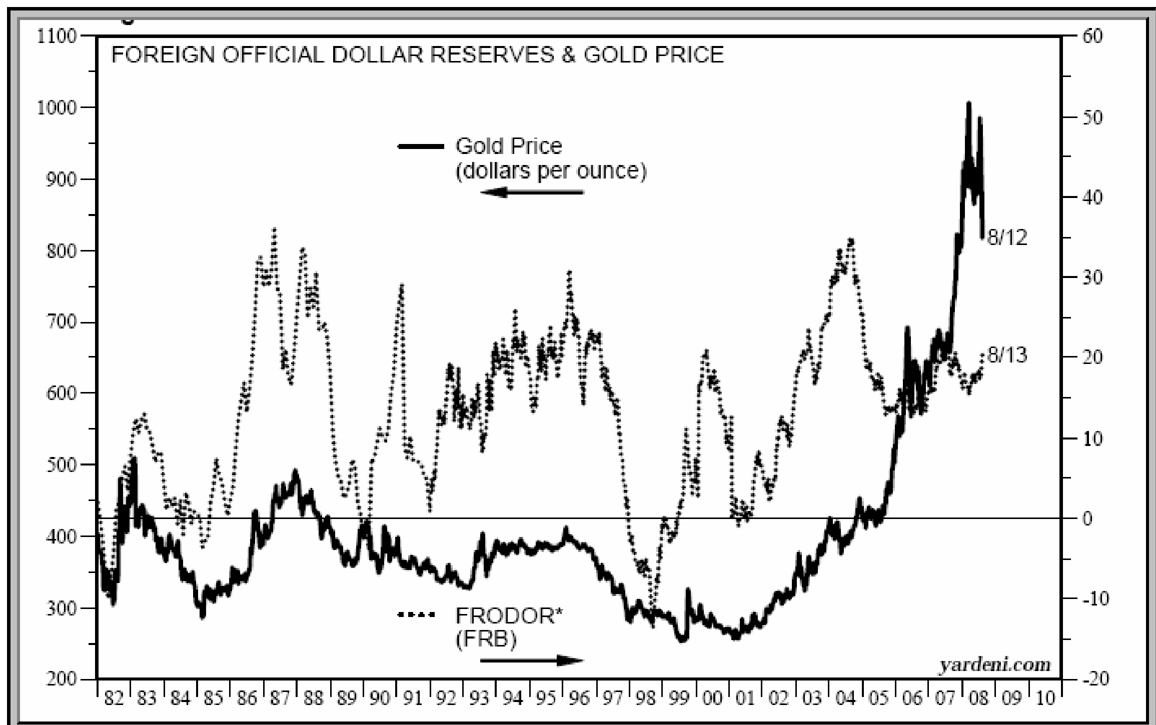


Figure 8: Correlation between FRODOR Growth and Gold



Source: Ed Yardeni, www.yardeni.com

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I have a friend who is an outstanding economist who thinks that the Asian current account surpluses will shrink in 2009 by about 50% from their peak in 2007. In this scenario, global liquidity would become extremely tight and would have a devastating impact on asset markets including real estate, commodities, non-AAA bonds and equities. Such a decline in the Asian current account surpluses would cut the US current account deficit by half and lead to a very strong USD. Another friend of mine is a global strategist (his team was voted best global strategy team). He thinks the S&P will decline to 500, which would imply a Dow Jones that is between 5000 – 6000 (see Figure 9).

Figure 9: Dow Jones Industrial, 1970 - 2008

Source: www.elliottwave.com

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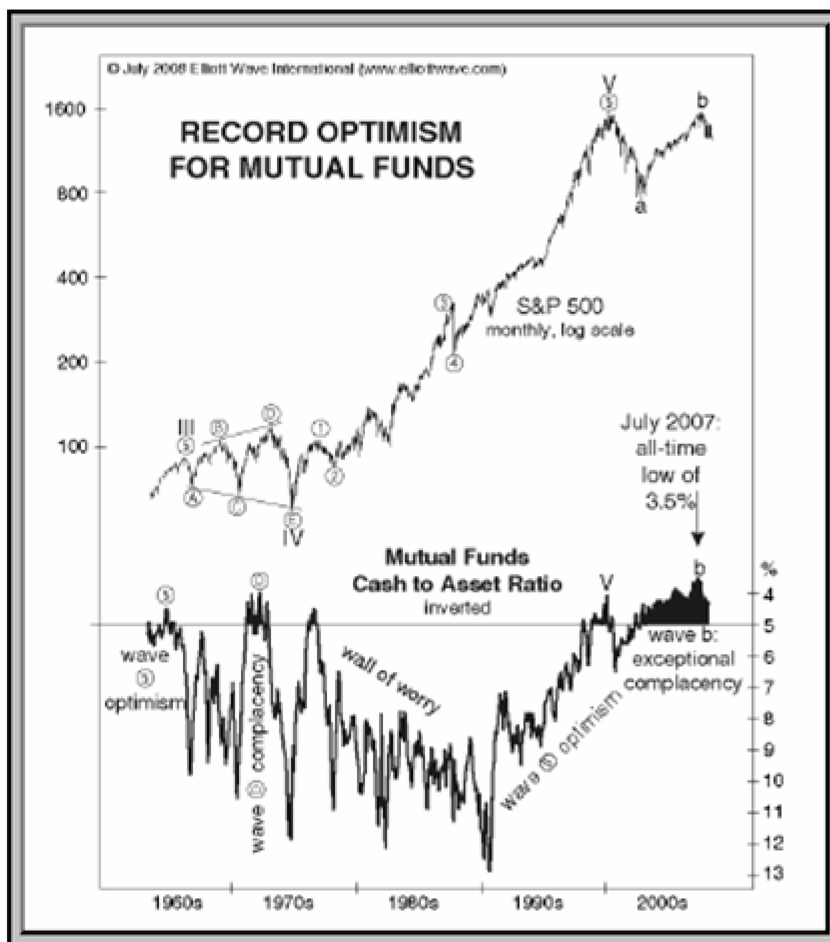
Now, 500 for the S&P 500 would seem like an extreme prediction. But if indeed the global economy slumps and liquidity tightens as much as a decline of the US current account deficit would imply, we could be in for a nasty shock in all asset markets. I should also like to emphasize that the Dow has now broken below its long term trend-lines going back to 1974 and 1982 (see Figure 9). Also a new bull market is unlikely to get underway soon because mutual fund cash positions are still very low (see Figure 10).

Figure 10: Mutual Fund Cash Positions, 1960 - 2008



Source: www.elliotwave.com

Please compare today's cash positions to the cash positions which existed at the 1982 (12%) and 1990 (13%) market lows! Over the last 18 months, households have been heavy sellers of equities (in order to maintain their spending). The support for equities in 2007 came only from LBOs and share repurchases (see Figure 11 and Figure 12).

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Figure 11: Less Demand for Equities from Share Repurchases

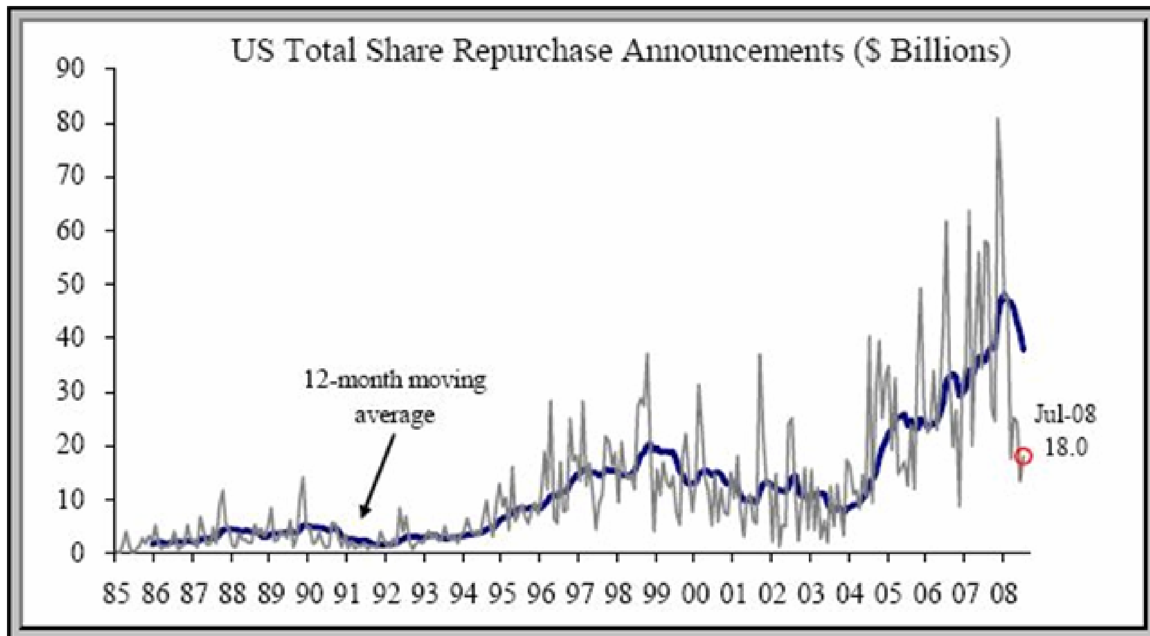
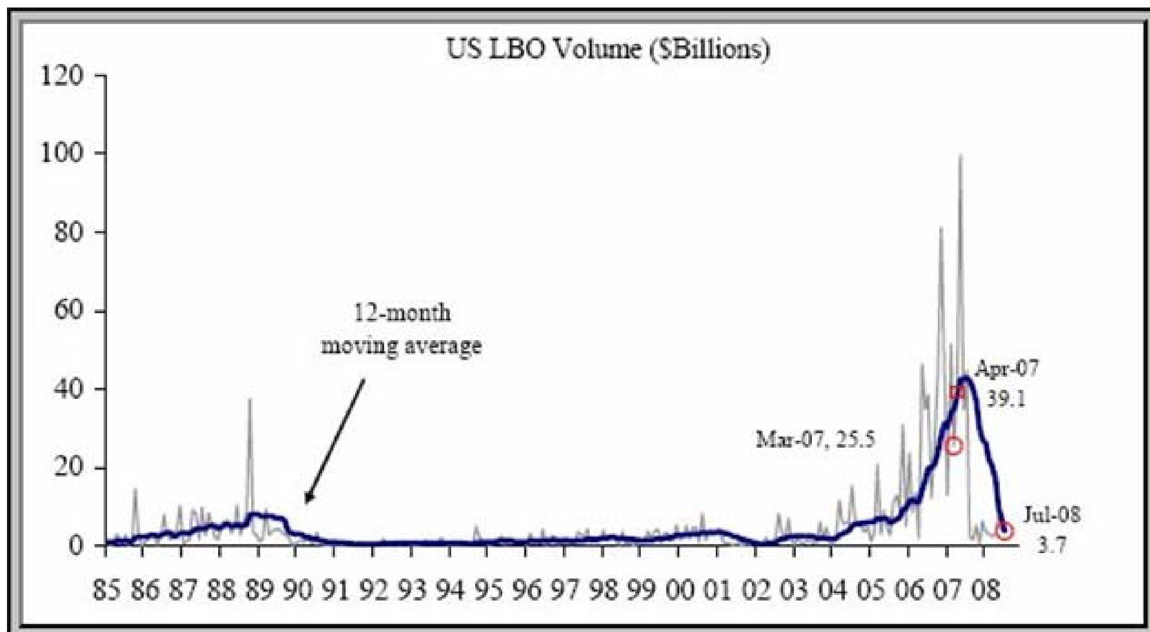


Figure 12: Less Demand for Equities from LBOs



Source: Gerard Minack, Morgan Stanley

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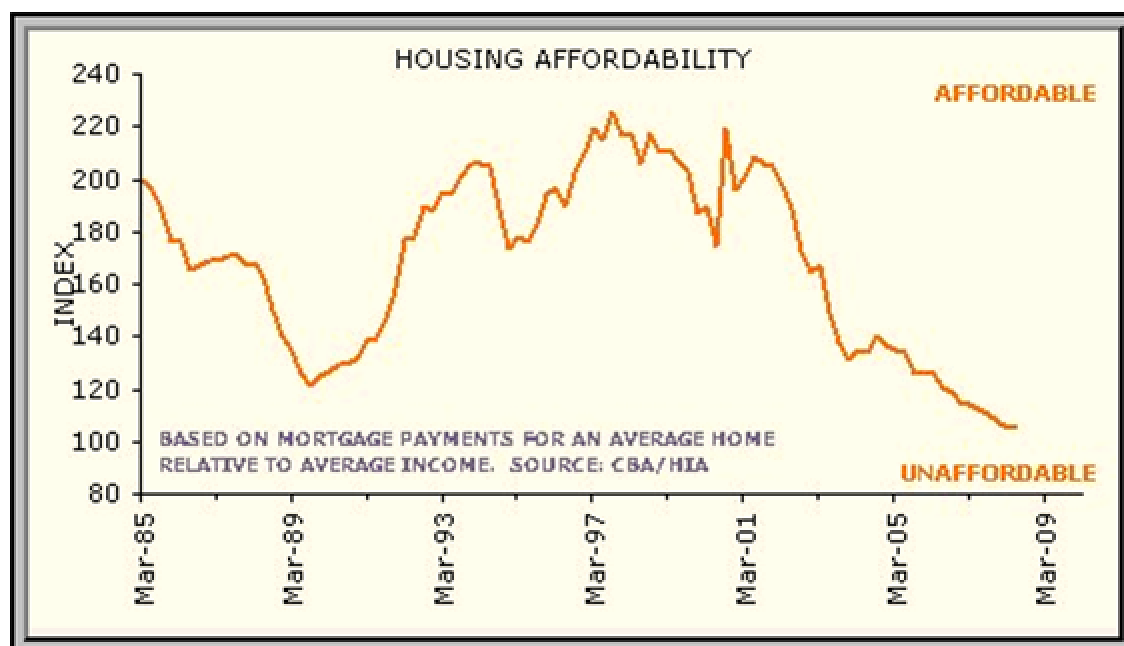
The demand from these important sources has now collapsed and will not come back as long as lending standards are not eased considerably and as long as the outlook for the global economy deteriorates.

I have to stress that markets outside the US are even more vulnerable. The US economy is in deep trouble but this is now widely known whereas other economies such as Australia, the UK and the Eurozone are just starting to deteriorate very badly, frequently from an even more inflated level. So while housing affordability has improved in the US as a result of the sharp price decline, affordability in Australia is at a record low (see Figure 13).

Figure 13: Australia: Record Low Housing Affordability



Source: Gerard Minack, Morgan Stanley

So, I still maintain that US stocks will continue to outperform foreign equity markets as they have since the beginning of the year. This is not because I think that US equities will move higher but because they are likely to move down less than foreign markets and also because the USD should continue to strengthen. Central banks around the world will shortly begin to cut interest rates, which supported foreign currencies so far. In particular, I regard the New Zealand dollar, the Australian dollar and the British Pound to be vulnerable.

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In the US, the most vulnerable sectors are now material and energy related companies and increasingly the last sector that has held up well: technology including companies such as Apple (AAPL), Research in Motion (RIMM), Amazon.com (AMZN), Google (GOOG) and IBM (see also Figure 14).

Figure 14: NASDAQ 100, 2005 - 2008

Source: www.decisionpoin.com

In recent commentaries we have also suggested that Japanese equities were **relatively** attractive. As can be seen from Figure 15 they have begun to outperform the Hang Seng Index and also other Asian markets and I expect this outperformance to last for some time. Again, this does not mean the Japanese stocks will move up but that they will move down less than other Asian markets.

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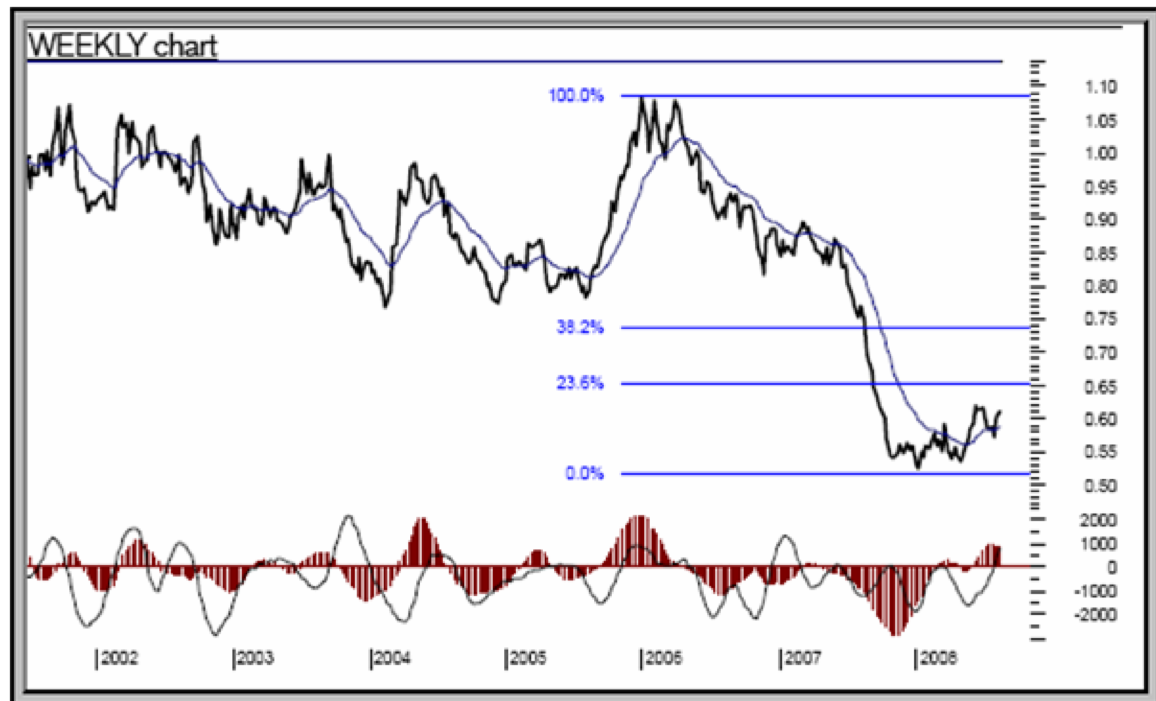
Figure 15: Japan Nikkei 225 Index relative to Hong Kong Hang Seng Index, 2002 - 2008



Source: www.credit-suisse.com/techresearch

In sum, credit growth and global liquidity are contracting, a vicious economic downturn is about to unfold (China could surprise on the downside and put additional pressure on commodity prices) and asset markets are still very high by historical standards and, therefore, remain vulnerable. I would use equity rallies as a selling opportunity and further weakness in gold as a buying opportunity for long term holders with significant cash and cash flows. But if my strategist friend is right and the S&P 500 trades down to the 500 level you should be careful not to be eaten by bears in all asset markets (see picture below).

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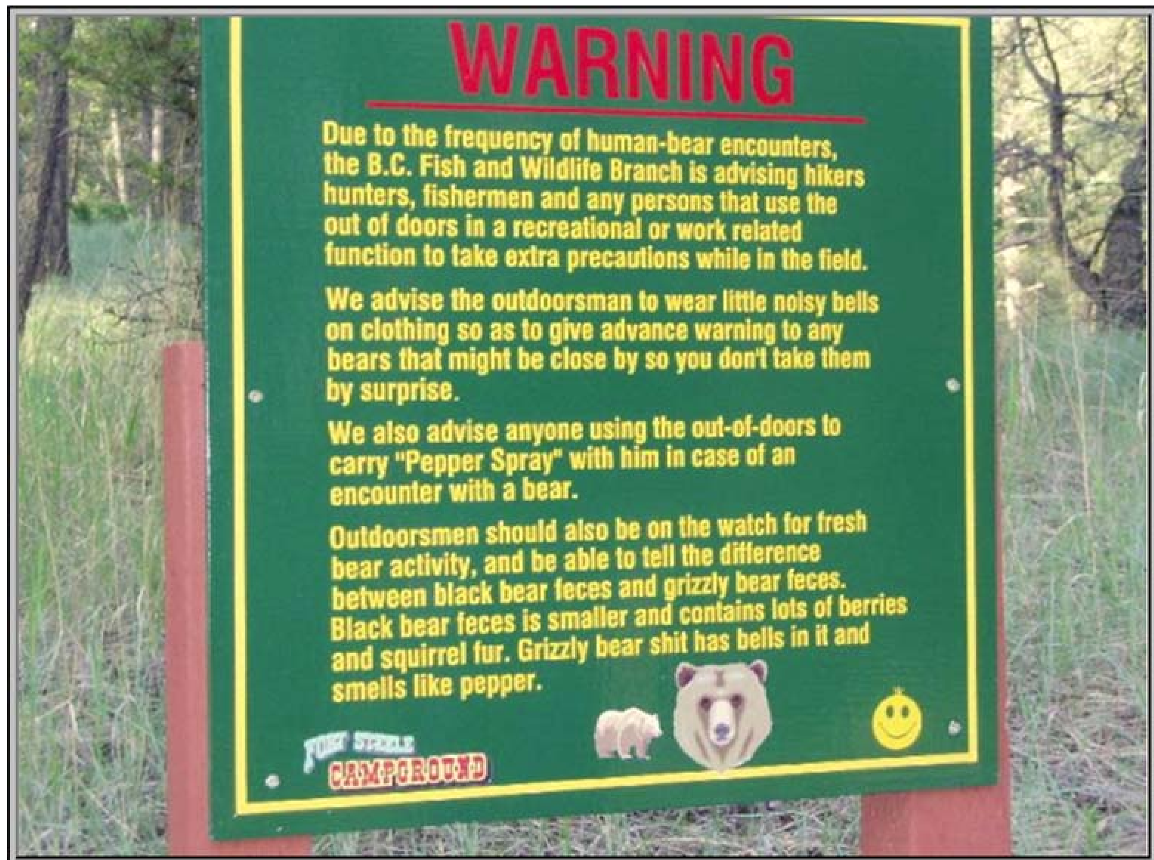
I am enclosing with this commentary a report by my friend Eric Kraus about Georgia. I think it is well-worth a read since Eric has deep historical and geopolitical knowledge.



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