Further Improvement in Asset Markets but Correction Is Overdue!

Marc Faber

> **"The sacrifices of friendship were beautiful in her eyes as long as she was not asked to make them."**
> **Hector Hugh Munro (better known by his pen name "Saki")**

> **Banking was conceived in inequity and was born in sin. The bankers own the earth. Take it away from them, but leave them the power to create deposits, and with the flick of the pen they will create enough deposits to buy it back again. However, take it away from them, and all the great fortunes like mine will disappear and they ought to disappear, for this would be a happier and better world to live in. But, if you wish to remain the slaves of bankers and pay the costs of your own slavery, let them continue to create deposits.**
> **Lord Josiah Stemp, Former Director of the Bank of England (1937)**

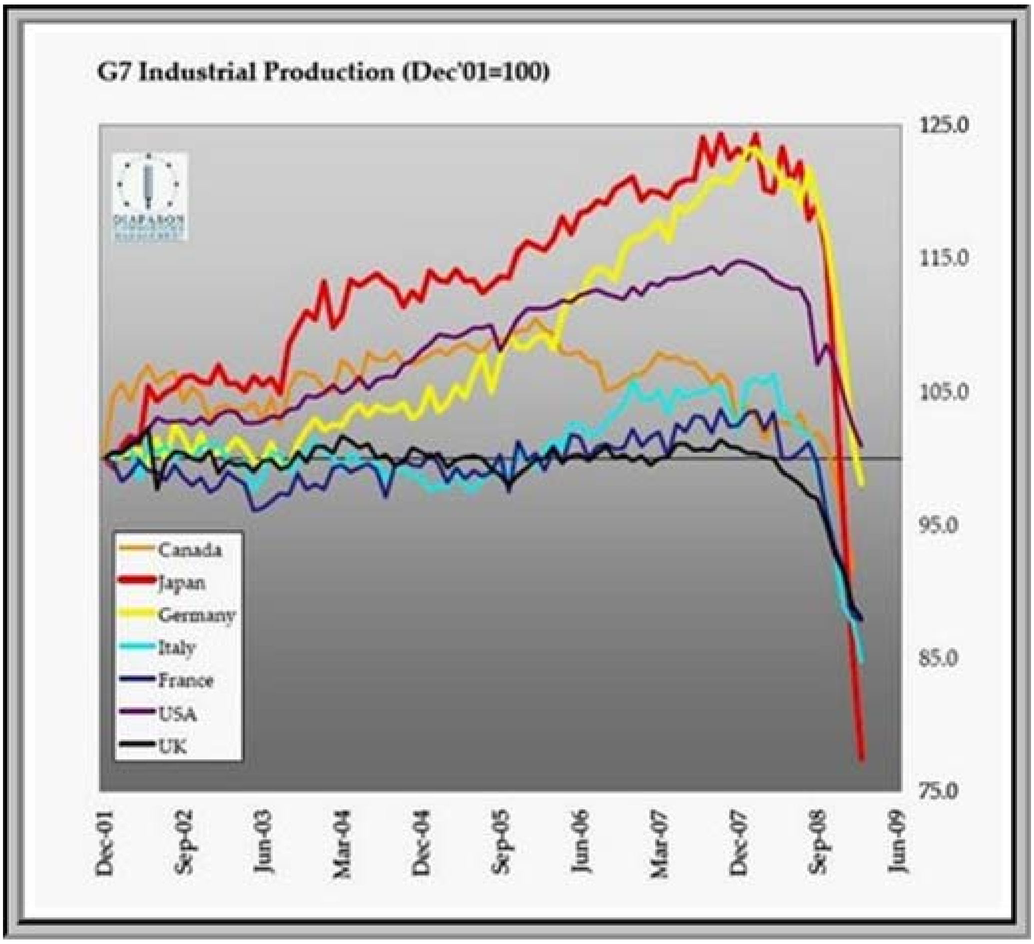
The economic news in the world is hardly getting any better, but the rate of economic contraction has slowed down somewhat as the governments' stimulus packages begin to have some impact and as some replacement demand is starting to support consumption. However, to talk already now about a sustainable economic recovery seems premature because whereas some sectors (autos) and regions may be stabilizing, others are still in a steep decline. According to Spain's national statistics institute, the rate of unemployment in Spain rose 3.45% to **17.4%** in the first quarter of 2009! The number of unemployed increased by 1.8 million to 4.01 million people, the highest in 10 years. Unemployment increased in all sector, but in particular in the services industry. According to some experts, unemployment in Spain is set to increase further in the second half of the year, although at a lesser rate. It is estimated that by the end of the year, unemployment could reach 20%.

BTA, Kazakhstan's largest bank, announced that it could no longer repay $11 billion in foreign debt and that it would only pay interest to foreign creditors. This announcement underscores the growing financial instability in former Soviet Union countries (BTA bonds are trading around 21cents on the dollar).

And in the UK, the government had another brilliant idea in order to boost economic growth! It will boost the top income tax rate to 50% starting in 2010. This will apply to any incomes above 150,000 British Pounds (as someone once remarked, "never in the history of the world there has been a situation so bad that the government can't make it worse").

Therefore, I regard it as almost impossible for the global economy to fully recover to the economic activity level that we reached at the peak of the 2001 – 2007 expansion, which likely took place sometime in 2006/2007 (see Figure 1)

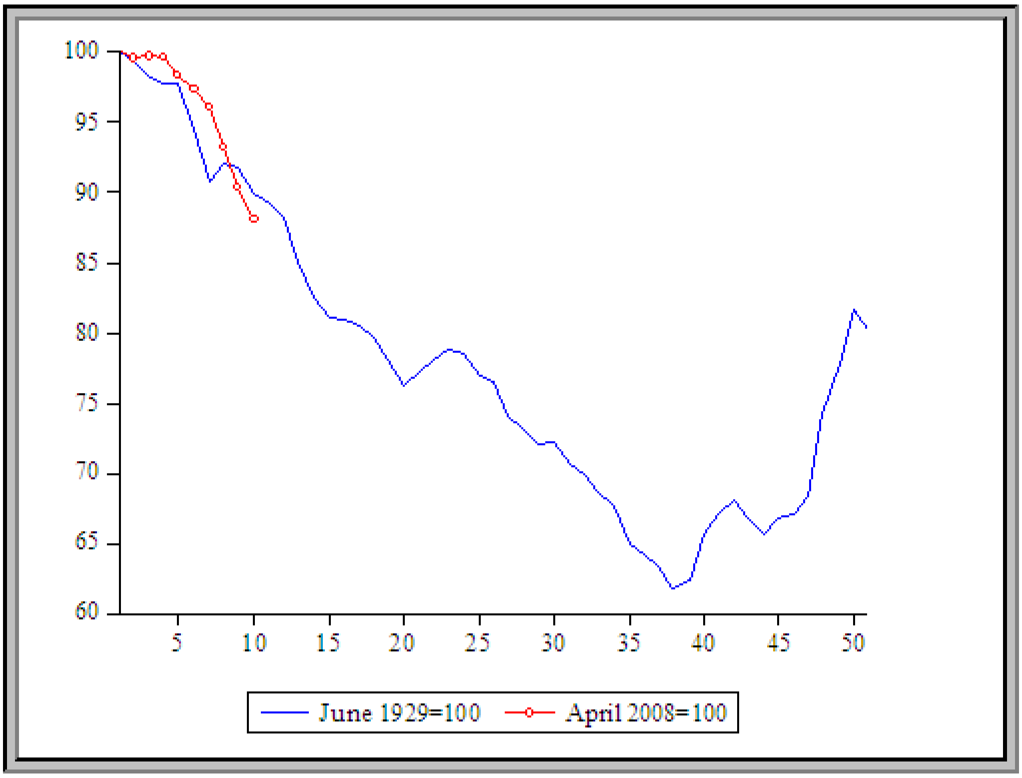
Figure 1: Full Economic Recovery Not Likely in the Foreseeable Future (Industrial Production 2001 – 2009)



Source: Diapason Trading

From Figure 1 we can see how badly the Japanese economy has been hit. In February its industrial production fell 38% year-on-year. In the 1930s, no major economy imploded at the speed Japan has been contracting since September 2008. I should add that the decline in global industrial production in the last 9 months is as severe as it was in the nine months following the 1929 peak (see Figure 2, which shows the behavior of global industrial production in the 50 months that followed the June 1929 and April 2008 peak).

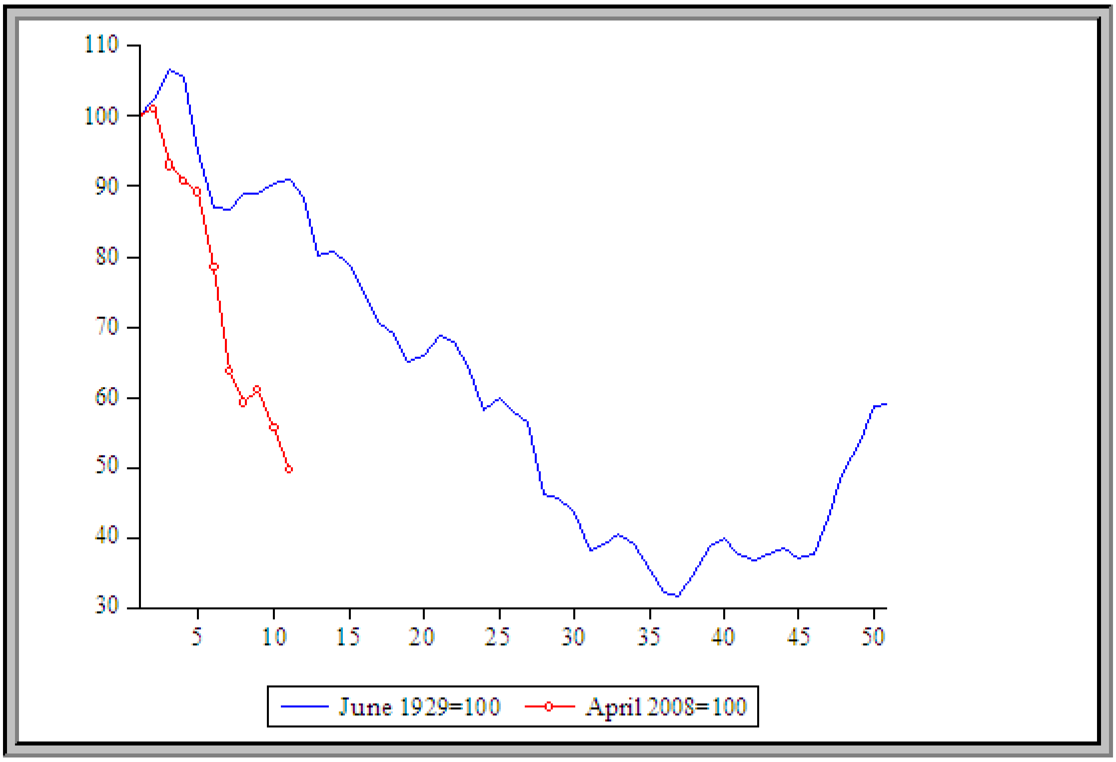
Figure 2: World Industrial Output, Current Recession Compared to the 1930s



Source: Barry Eichengreen and Kevin O'Rourke, A Tale of Two Depressions (2009).

But, whereas global industrial production has declined in the current contraction at about the same rate as in the period that followed the June 1929 peak, global trade and global stocks have collapsed at a much faster rate (see Figure 3).

Figure 3: World Stock Markets in the 50 months following the June 1929 and April 2008 Peak in Global Industrial Production



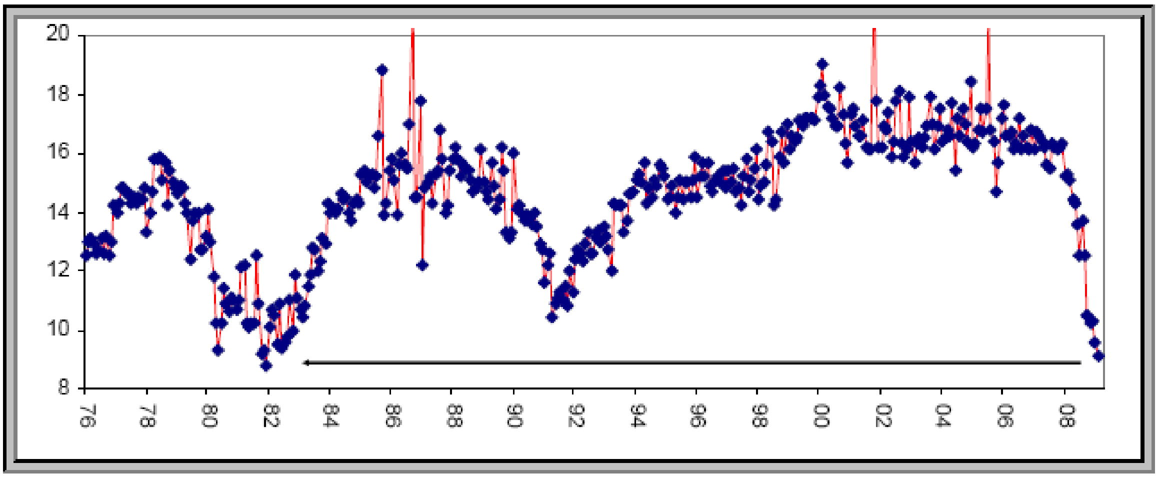
Source: Barry Eichengreen and Kevin O'Rourke, A Tale of Two Depressions (2009).

Aside from all economic and financial problems we are facing we now have two additional problems to deal with. One of them is the swine flu, which originated in Mexico and has already spread very rapidly to dozens of other countries. Should the swine flu become a full-fledged and deadly pandemic (very likely in my opinion) the impact on the global economy could be devastating. In particular, I am concerned that the rapid and constant movement of people and goods around the world renders the containment of an epidemic impossible. In the case of the SARS epidemic in 2003, the disease spread within a matter of weeks to 37 countries and led to a sharp decline of economic activity in Hong Kong and Singapore. In April 2003, tourist arrivals in the most affected economies dropped by over 50% and in other less affected economies by between 20% and 40% (I suppose this will now be the case in Mexico where tourist arrivals could decline by 99% if the swine flu's fatality spreads). Also, in the first half of 2003, Hong Kong's and Singapore's economies shrank by 2.6% and 2% respectively, which looks mild in comparison to how Hong Kong looked at the peak of the SARS epidemic (the airport looked like a ghost-town, in some hotels occupancy rates dropped to less than 5% and night clubs were empty).

But the point is that if the Swine flu becomes a serious problem (as I believe it will), then obviously it will be another nail in the coffin of the global economy. I hate to think about what will happen when the Swine flu reaches Africa and countries like India and China where intensive animal husbandry methods place swine and poultry close to humans and where sanitary conditions, poverty and a poor health infrastructure will be an extremely fertile ground for the swine flu virus (also further mutations). The other problem, which I think could become explosive, is the situation in Afghanistan, and especially in Pakistan, which possesses nuclear weapons (I shall have to deal with this issue another time).

So, rest assured dear readers: economic, financial, pandemic, and increasingly social and geopolitical problems are plentiful and won't disappear anytime soon. However, economic activity has already reached extremely depressed levels in some sectors (see Figure 4 and 5).

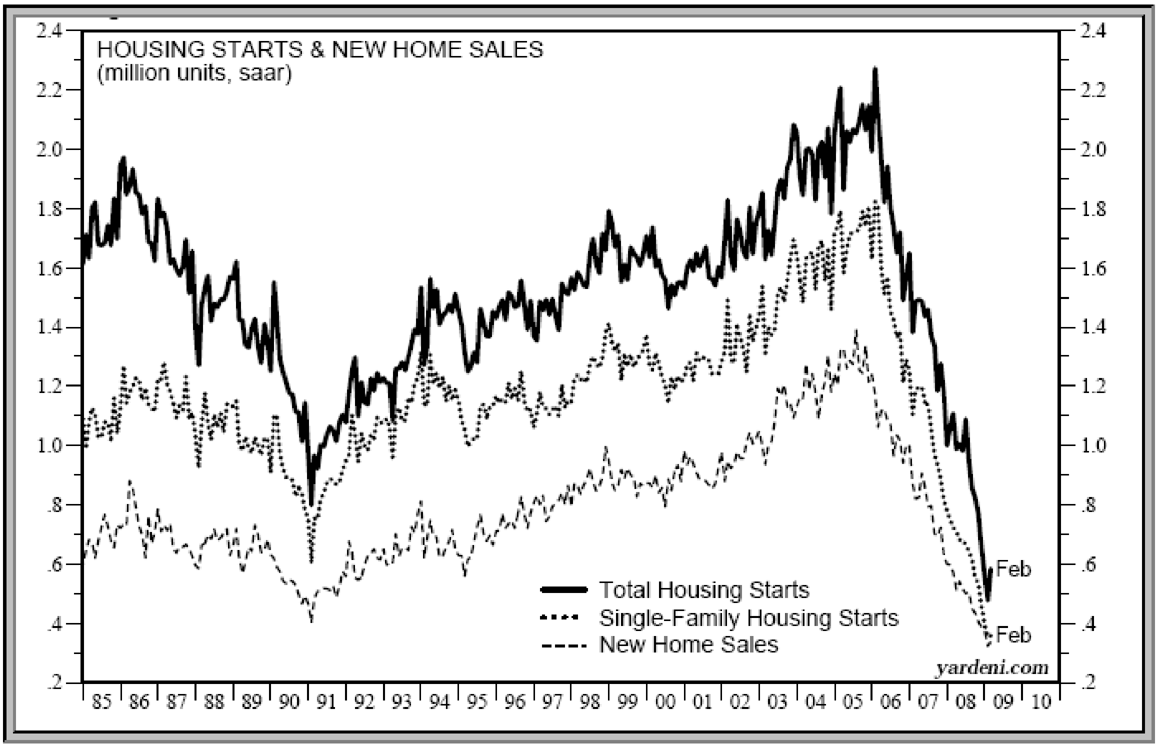
Figure 4: US Auto Sales (Millions of Units Annualized), 1976 - 2009



Source: Bridgewater Associates

US car sales are even more depressed than indicated by Figure 4 because the US population has expanded since 1981 from about 200 million to over 300 million. Obviously, cars will need to be replaced at some point in the future, which will lead to a rebound in sales and production. Similarly, the housing industry is going to bottom out one day and housing starts and homebuilders will recover (see Figure 5). However, it should be clear that neither homebuilders nor housing starts will recover to the 2006 peak any time soon as inventories remain huge and financing difficult to obtain (nor will auto sales return to their peak soon).

Figure 5: US Housing Starts and New Home Sales, 1985 - 2009

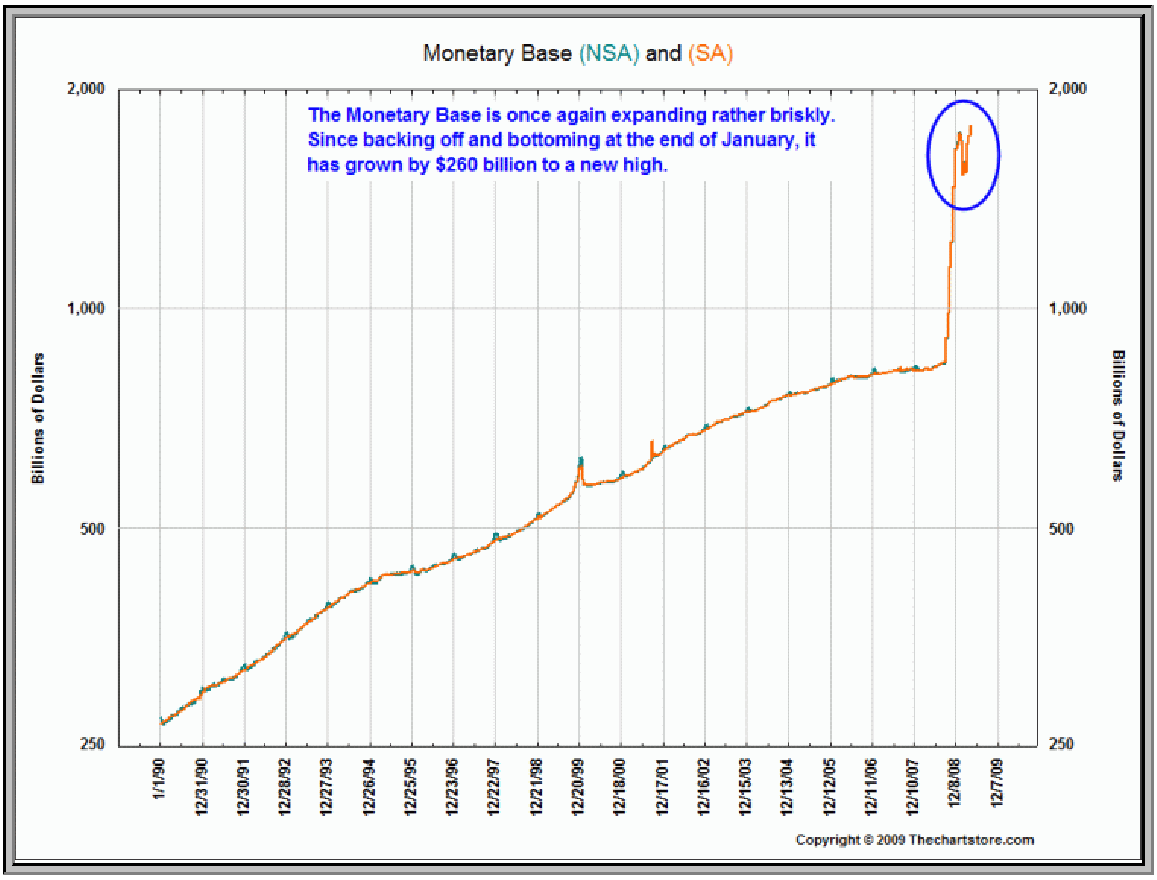


Source: Ed Yardeni, www.yardeni.com

But, as I have pointed out in recent reports, the stock market will usually (not always, however) respond with an upturn long before the "news" turns positive. I suppose the key for a low is that the news becomes less bad than was expected, which was the case in the US since March 6, 2009 when the S&P 500 bottomed out at 666.

Moreover, central banks worldwide – especially in the US – are running the money printing presses at full speed in order to "inflate" (see Figure 6).

Figure 6: US Monetary Base – Up Forever and Into the Stratosphere!



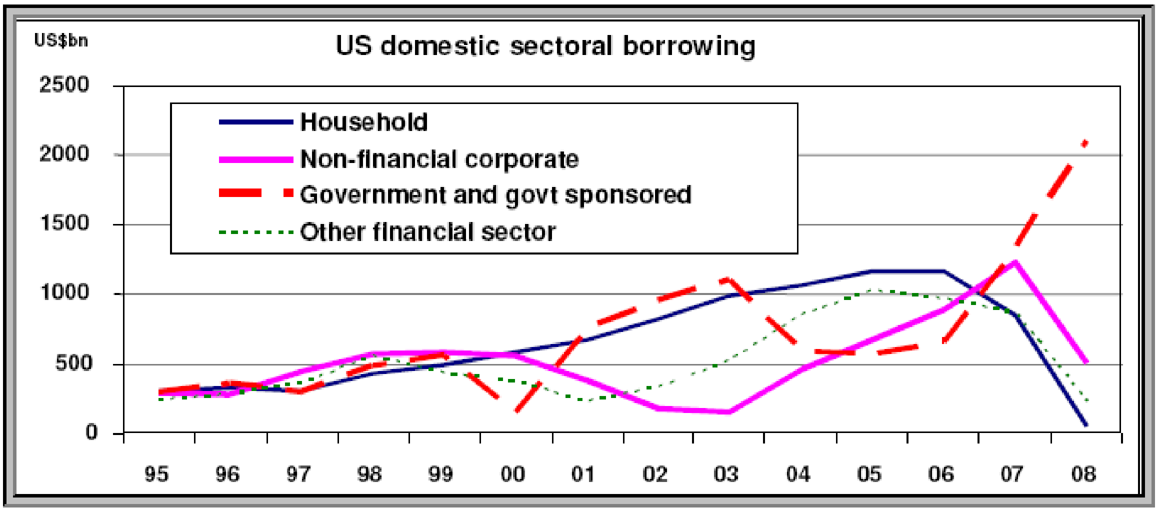
Source: Ron Griess, www.thechartstore.com

Now, from the numerous emails I get I have the impression that most investors are leaning toward the view that "deflation" will be the problem in the future and not "inflation." An "expert" even opined that whereas it was possible under a pure paper money system (large quantity of banknotes in circulation) to create high inflation rates, this was not possible under an electronic banking system.

But consider for a minute the following sequence of events. The economy contracts and the government decides to combat the recession through a large budget deficit and through cuts in short term interest rates in order to stimulate consumption and to support and boost asset markets. Usually - but not in balance sheet recessions – artificially low interest rates will stimulate private sector credit demand and bring about a temporary economic recovery (not sustainable in the long run, however). If, however, monetary policies alone fail to even temporary revive the economy (easy monetary policies cannot create sustainable "real" prosperity), fiscal policies will usually be used to assist monetary policies in the government's effort to bring about the eternal prosperity to which we Westerners are all entitled to through our birthright. After all, we have our unshakable democratic constitutions, very honest government officials, far-sighted economic policy makers, a Christian religion, an irreplaceable Caucasian race, and most of all, we have outstanding academic skills in terms of our superior ability to comprehend, invent and innovate - in particular in the for humanity crucial field of new financial products and cutting edge financial technologies.

But for the fiscal stimulus to even have a small chance of succeeding at reviving economic activity it has to be larger than the private sector credit contraction (see Figure 6 and 7).

Figure 7: US Private Sector Credit Contraction Is Offset by Public Sector Credit Expansion!



Source: Halkin Services, halkin@halkinservices.co.uk

I personally doubt the sustainable success of such Keynesian economic policies. In other words, if a government believes in Keynes it is likely that the financing of the growing fiscal deficit (government expenditures going up at a time when government receipts in the form of income taxes decline because of the recession) would put some upward pressure on interest rates (see Figure 8). That is, unless the central bank massively monetizes the securities the Treasury issues in order to finance its deficit. In simple English the Bank of England or the US Fed buy the bonds and bills the government issues and pays the respective governments with freshly and "out of thin air" created electronic money. As an economically very well educated friend of mine says, "it makes no difference macro-economically if a mafia boss produces counterfeited dollar bills in his cellar or the Fed prints money." (I think it does make a difference because the mafia boss is very efficient at allocating resources and eliminating inefficient market participants – hence the monetary inflation is partially offset by vast productivity improvements in the system.)

Figure 8: The Inflationary Problem Begins!

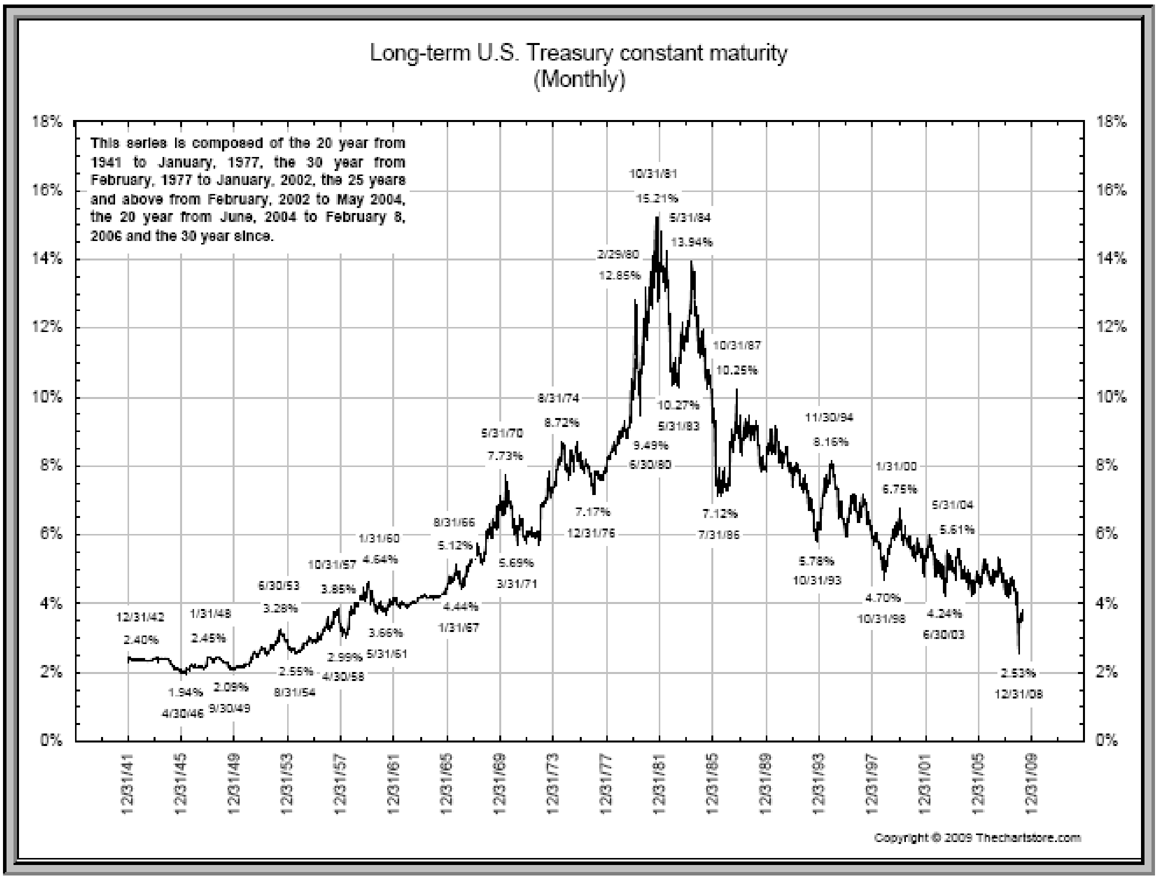
Source: www.decisionpoint.com

Just above, I mentioned that interest rates would rise if exploding fiscal deficits were not being at least partially monetized by the central bank. But this is not entirely correct: in the case of monetization the central bank may succeed at keeping short term rates down but it will have little success at "manipulating" down yields on longer term fixed interest securities. Certainly not in the long run! And here lies the crux of the problem most deflationists do not understand. By keeping short term rates artificially low and by monetizing the growing fiscal deficits a central bank digs its own grave in terms of its ability to pursue tight monetary policies when such policies become necessary. Why?

Referring to Figure 7 (see above) I explained that the US Treasury and the Fed are attempting to offset the private sector credit contraction through fiscal deficits and monetization (the Treasury and the Fed are now in the same boat, which is wrong because a central bank should be "independent" in order to be effective and credible – unfortunately I am not aware of any "independent" and "credible" central bank). The problem may, however, be that there is already excessive leverage in the private sector because the central bank may have previously kept interest rates artificially low (read the period between 1997 and up to this very date). In case there is excessive leverage in the system, it is likely that the economic contraction will be accompanied - or more likely will even have been caused - by the inevitable collapse in asset prices.

I sincerely hope that at this point our readers will ask why there was excessive leverage in the system in the first place, which then caused the collapse in asset prices. Answer: Please return to the paragraph above starting with "but consider for a minute the following sequence of events." But now our readers should also think about this: If the US Fed failed to tighten monetary policies after the US economy began to recover in November 2001, what are the chances of tight monetary policies in the future (which would significantly increase in the short run the cost of servicing the government's debt) when both the US government and the Fed will be loaded with toxic assets and burdened by all kinds of other liabilities? The chances of the US government implementing tight monetary policies in the next few years are exactly **zero.** Just read the academically stimulating economic sophism of Harvard economic professor Gregory Mankiw, who was an advisor to President Bush and, on February 1, 2000, dead ahead of the NASDAQ collapse, expressed the view in the Wall Street Journal that **"when you look at the mistakes of the 1920s and 1930s, they were clearly amateurish. It is hard to imagine that happening again—we understand the business cycle much better."** For the record, professor Mankiw is strongly suggesting creating negative real interest rates through inflation and believes that Mr. Bernanke is the best man to do this job….. I should add that negative real interest rates post 2001 caused the current problems in the first place. My friend Heinz Blasnik thinks that Mankiw's idea "is so hare-brained, I wonder if he needs a spell in a mental institution to recover his mind." (Blasnik is kinder to Larry Summers who while asleep at important meetings "cannot do much harm.") But my point is simply this: Once a government embarks on highly expansionary fiscal policies which entail government expenditures vastly exceeding revenues (leading to enormous budget deficits and soaring government debt) and simultaneous monetization ("printing money"), the reversal of these inflationary policies becomes for all practical purposes impossible. Inflation and higher interest rates follow (see Figure 9).

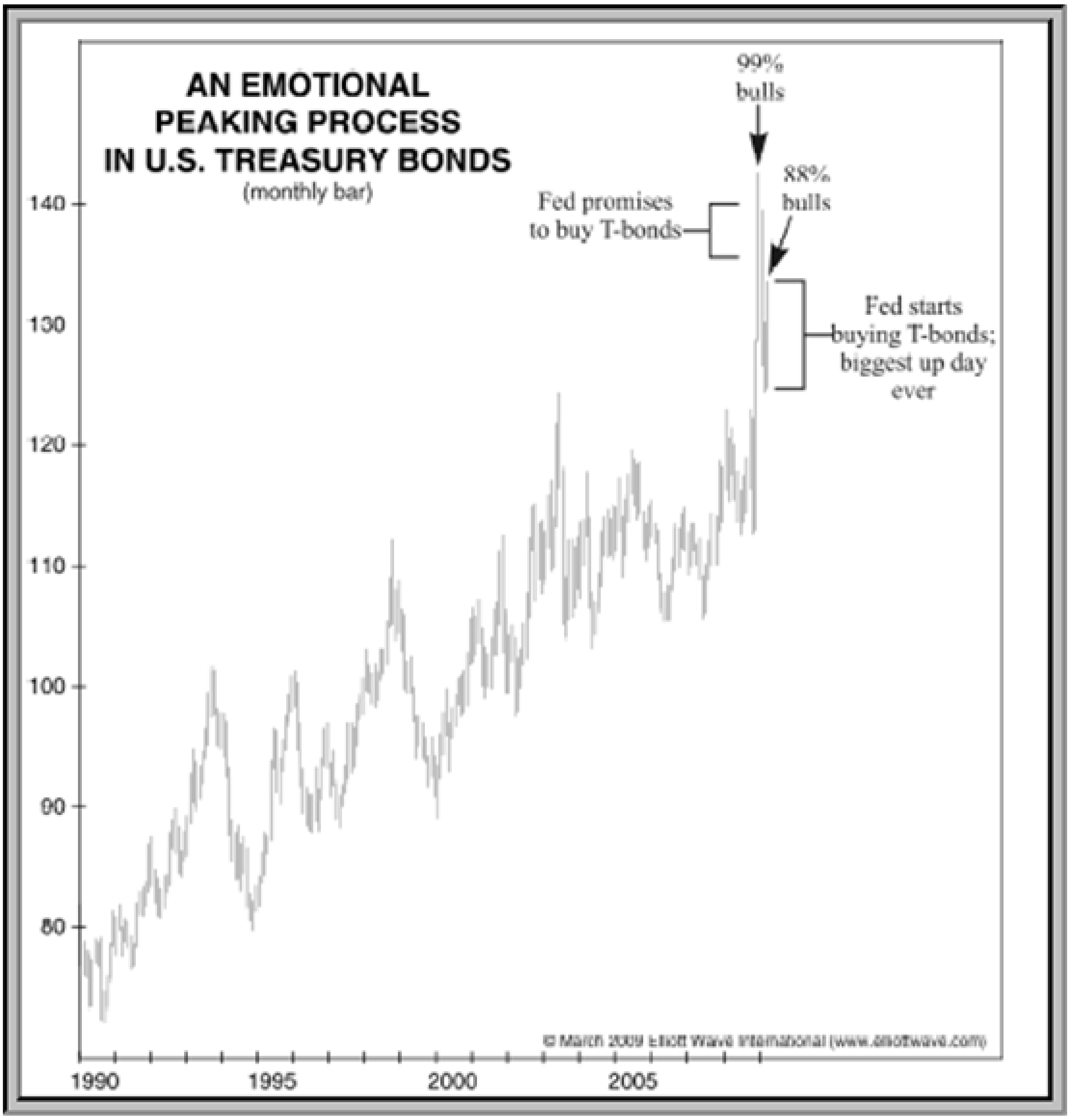
Figure 9: Has the Secular Bull Market in Government Bonds Ended?



Source: Ron Griess, www.thechartstore.com

At this point the reader should clearly understand that any upward pressure on interest rates brought about by the market participants will actually force a central bank that embarked on monetization to monetize even more (see Figure 6 and 8). The other point to remember is that the longer an economy does not respond to such "inflationary" fiscal and monetary policies, the larger the "doses" will become (the reason why weak economies will tend to have higher inflation rates than strong and well balanced economies). For all these reasons and also because investors' sentiment became late last year and again this year so "bullish," I would avoid Treasury bonds and short them on any rebound (see Figure 8 and 10).

Figure 10: Bullish Sentiment Reached Extremes Recently!

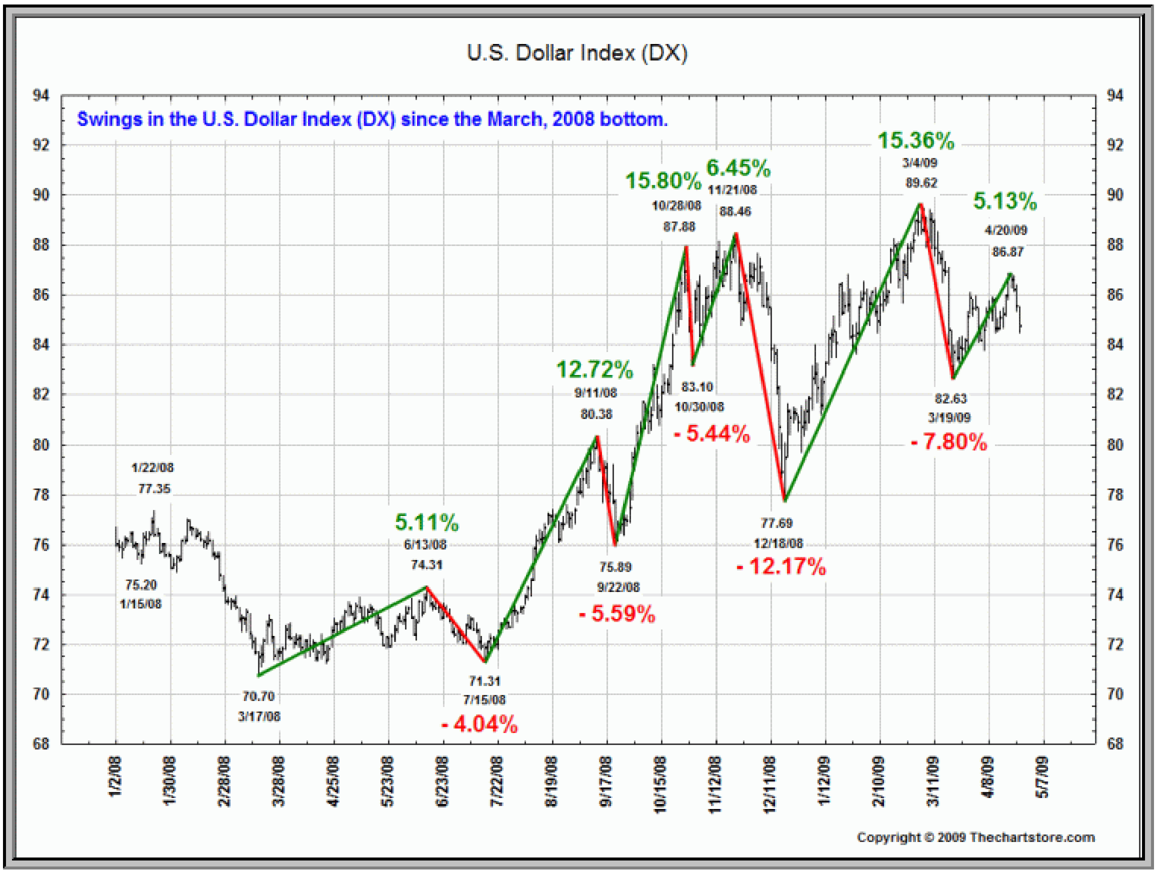


Source: www.elliottwave.com

Some readers may at this point wonder why I would go so far out of my way to make a case against investing in bonds. In fact, the reason for explaining in detail why long term US government bonds are unattractive has more to do with equities. If government bonds are indeed unattractive, where should investors put their money, which in cash at zero percent interest (and the prospect of negative interest rates in the future – see Mankiw" views above) is bound to lose its purchasing power.

As I have repeatedly explained in this report in the past, investors should diversify out of the US dollar into foreign currencies (see Figure 11).

Figure 11: US Fiscal and Monetary Policies Likely to be Negative for the US Dollar



Source: Ron Griess, www.thechartstore.com

This is not to say that I am terribly impressed by any non-USD paper currency. But with the trio Geithner/Bernanke/Summers as the economic policy makers of the world's reserve currency I just cannot imagine how the US dollar would be anything else but weak in the longer term (another negative for US bonds). Therefore, I continue to advise purchasing commodity-related currencies (Canadian and Australian dollar) and Asian currencies, which could benefit from foreign investors' renewed interest in the Pacific region. As explained in the past, most Asian equity markets made 20 to 30 year lows between October and December of 2008. They have now rallied sufficiently (in some cases up by more than 50%) to give me confidence that the October/November lows were likely **"Major Lows"** (see also Figure 12).

Figure 12: Siam Cement (SCC TB), 2004 - 2009

Source: Bloomberg

Since some readers are interested in individual Asian stocks, I am listing here some of the shares I own among others. In Singapore: Fraser & Neave (FNN SP), United Overseas Bank (UOB SP), OCBC (OCBC SP), SIA Engineering (SIE SP), STE Engineering (STE SP), Singapore Airports Terminal Services (SATS SP), Thai Beverage (THBEV SP), and REITs such as Ascendas REIT (AREIT SP), Ascott REIT (ART SP), First REIT (FIRT SP), Suntec REIT (SUN SP), CapitaCommercial Trust (CCT SP), and ARA REIT (ARA SP). In Hong Kong: Swire Pacific (19 HK) and Sun Hung Kai Properties (HK 16). In Thailand: Bangkok Bank (BBL TB), Glow Energy (GLOW TB), Tipco Food (TIPCO TB), Thai Union Frozen Products (TUF TB), Siam Cement (SCC TB), Samui Airport Real Estate Trust (SPF TB), and CS Loxinfo (CSL TB). In India: ICICI Bank (IBN US) and Infosys (INFY US). In Taiwan: Chunghwa Telecom (CHT US). In Georgia: Bank of Georgia (BGEO LI – see Figure 13). I also own some Malaysian and Indonesian shares.

Figure 13: Bank of Georgia (BGEO LI), 2006 - 2009

Source: Bloomberg

I also have from time to time positions in a number of BRIC and other (mostly emerging market) closed-end country funds and ETFs such as Brazil ETF (EWZ), the Templeton Russia Fund (TRF), the Greater China Fund (GCH), the Asia Pacific Fund (APB), Taiwan iShares (EWT – see Figure 14), the Japanese ETF (EWJ), the Japan Smaller Capitalization Fund (JOF), the Morgan Stanley India Fund (IIF), the Turkish Fund (TKF) and the MSCI Emerging Market ETF (EEM).
I also own some commodity-related stocks including at times companies such as BHP (BHP), Rio Tinto (RTP), Newmont Mining, and Freeport McMoRan (FCX), CVRD (RIO) and Xstrata (XTAN SW – see Figure 15) Gabriel Resources (GBU CN), Ivanhoe Mines (IVN) and NovaGold (NG).

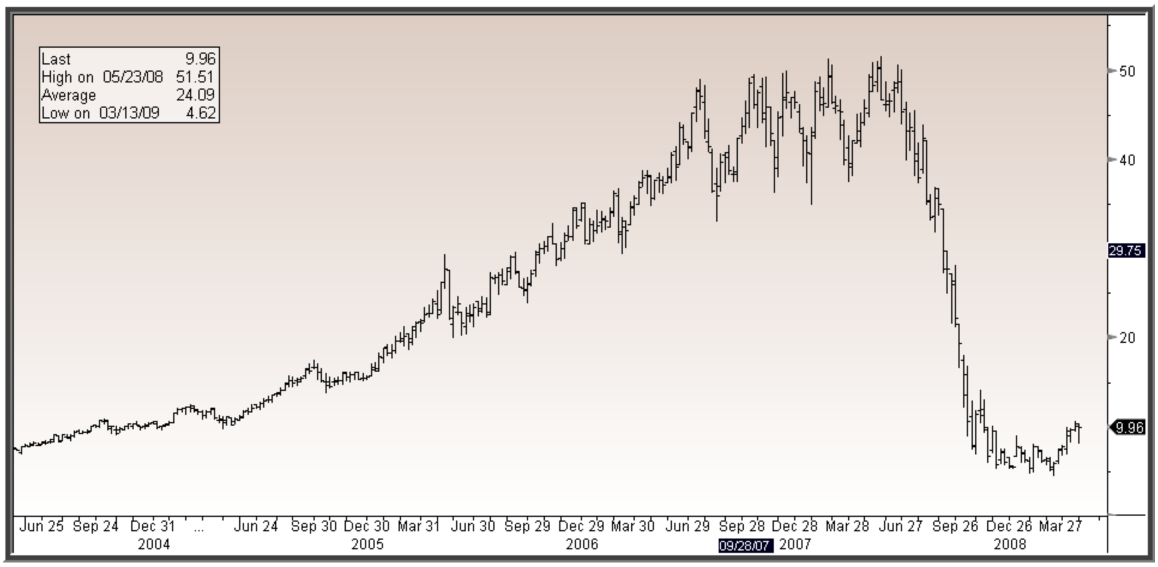
Figure 14: Taiwan Stocks in a Solid Uptrend!

Source: www.decisionpoint.com

In the US I have positions in some high tech companies such as Cisco (CSCO), Intel (INTC), Oracle (ORCL), and Yahoo (YHOO) and more recently I bought some beaten down insurance companies and financials as rebound candidates such as Leucadia National (LUK) and CNA Financial (CNA), and the Financials Select Sector SPDR.

What gives me some confidence that the March 6 low of the S&P 500 at 666 is an important low is that the market's advance has been broadening and that more and more groups such as airlines (AMR), homebuilders (TOL, CTX, HOV), and cyclicals like Dow Chemical (DOW), International Paper (IP) and Alcoa (AA) are showing signs of having bottomed out (please note that I cannot answer questions about individual stocks from investors).

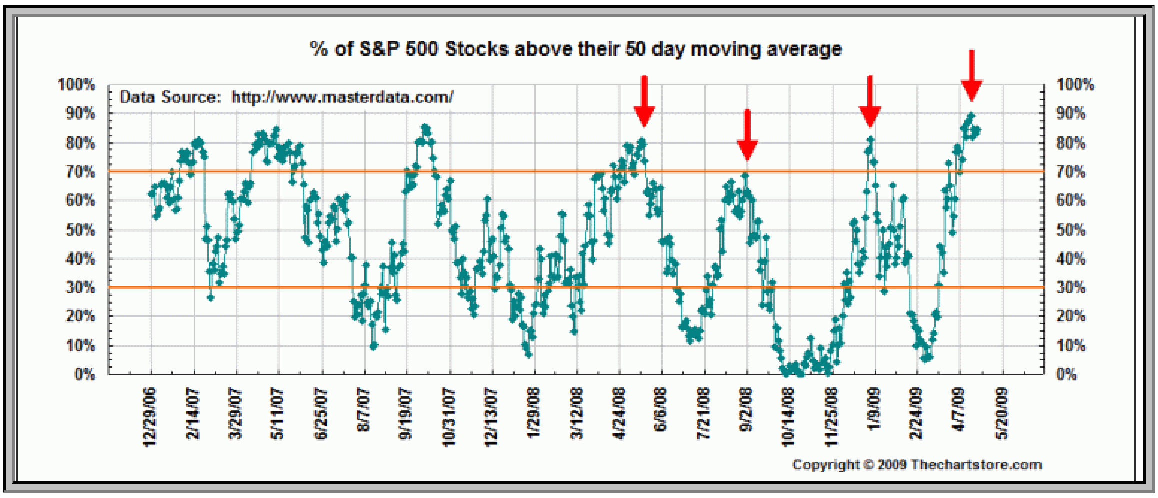
Figure 15: Xtrata (XTAN SW), 2004 - 2009



Source: Bloomberg

Of some near term concern is that insider selling has recently increased very rapidly and that the US stock market has become short-term overbought (see Figure 16).

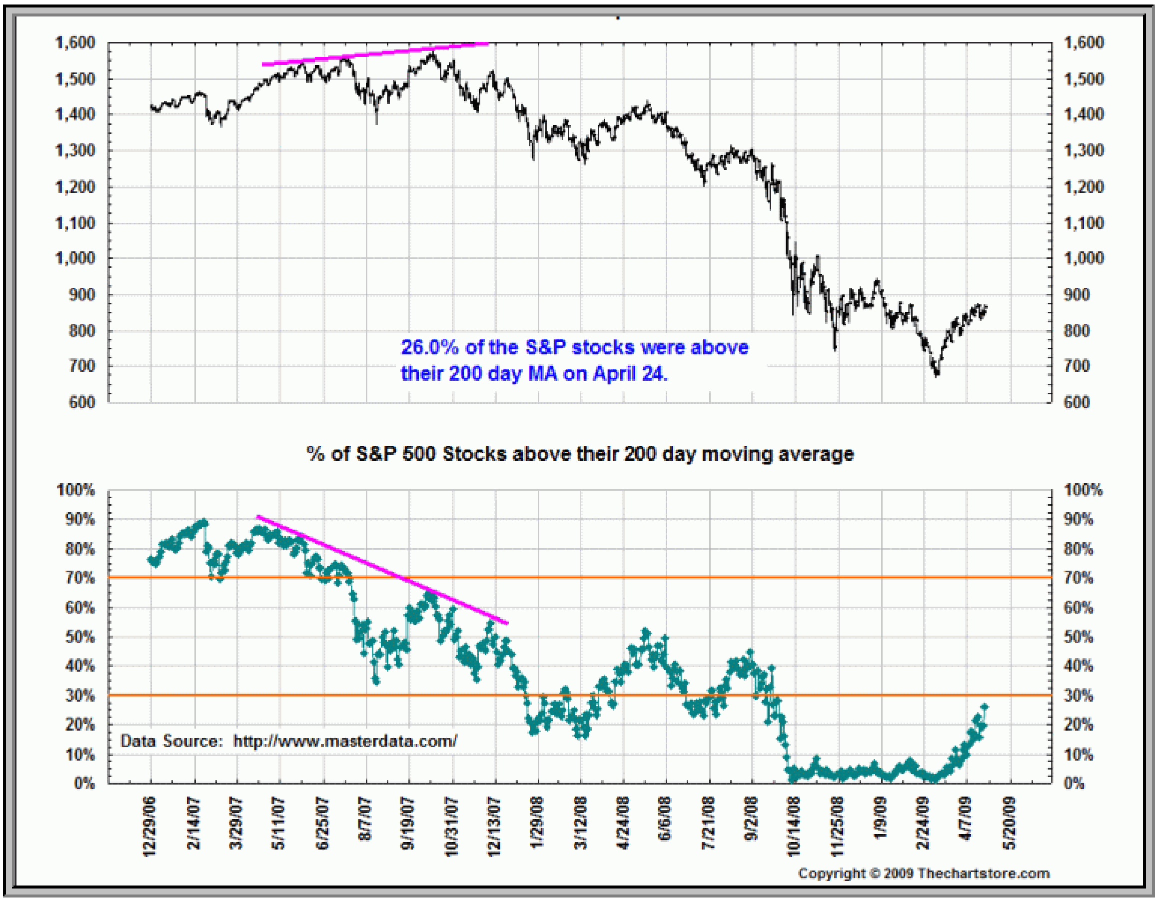
Figure 16: Short Term the US Stock Market Should Correct!



Source: Ron Griess, www.thechartstore.com

However, the medium term still looks positive and a further advance into July is likely (following a correction, which admittedly could be a sideward move). A rapid spread of the swine flu could trigger such a correction whereby it will be important that the S&P 500 does not decline below the November low at 741. A correction aside, my view is that the stock market has further upside potential until at least 60% of S&P 500 shares trade above their 200 day moving averages (see Figure 17).

Figure 17: S&P 500 and Stocks Above Their 200 Day Moving Average



Source: Ron Griess, www.thechartstore.com

I continue to recommend the purchase of physical precious metals but believe that precious metal prices may correct further on the downside in the next few months. Among commodities Sugar could well break out on the upside!

I am enclosing a report by my friend Jared Dillian about gold (dillian@dailydirtnap.com). Jared used to be Lehman's head ETF trader and now publishes an entertaining and interesting daily comment on financial markets.

I am also enclosing a very thoughtful and detailed report by my friend Fred Jones of Jutland Capital Management Ltd in Vancouver (fjones@jutlandcapital.com), who believes that “there is a latent problem brewing in global pensions and public funds – with the epicentre being in the US – that will command the attention of policymakers on at least two levels: firstly, the obvious problem of funding the retirement of workers that had the expectation of funds being available; secondly, the clear potential for social disorder stemming from the realisation that their expectations in retirement may differ greatly from the impending reality.”

In particular, Jutland Capital offers the facility to purchase and store physical gold (see report Pension Tension).

"Ours is a world where people don't know what they want and are willing to go through hell to get it."

Don Marquis (poet and play-writer, now mainly remembered as the creator of "Archy and Mehitabel," a cockroach and a cat who offered wry and witty reflections about life throughout the 1920s and 30s).