

# Green Shoots and California Red Woods

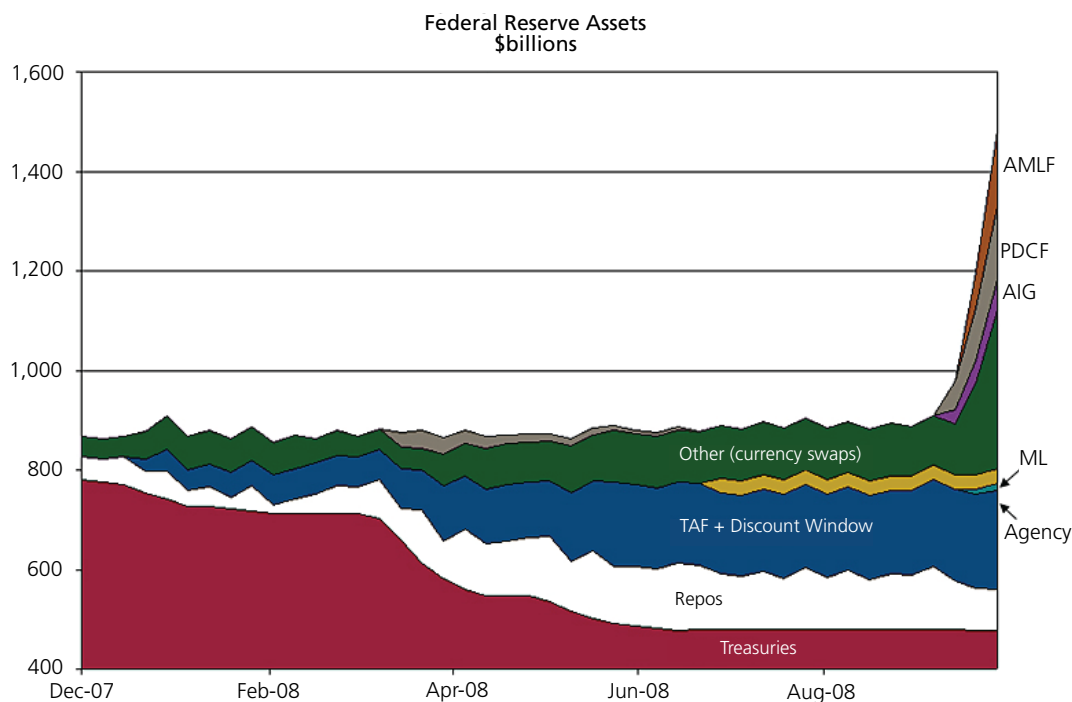
Ever since Ben Bernanke talked about starting to see 'green shoots' in the US economy the mood has changed, particularly in the equity markets.

Green shoots are those young, tender beginnings of regrowth after the destruction of the economic landscape in the past two years. Just what 'green shoots' are out there? The S&P has put up an impressive 36% return from its low of March 6, 2009. Everybody is talking about the equity market rally, the quick end to all the doom and gloom, inventory restock, blah, blah, blah – thumbing their noses at all the bears. Bond markets similarly have started to sell off, with US 10 year treasury yields have rising by 100 basis points (low of 2% in Dec to around 3.15% today).

The sell-off in the treasury market could be attributed to the following:

## 1. Deterioration of the Government balance sheet

The US treasury yields are rising at a rapid pace as the Federal Reserve is expanding its balance sheet.



Source: Federal Reserve Board H.4.1

Issuance of 100 billion US treasuries a week has become the norm. As the US Government takes on the burdens of guaranteeing bank debt, and bailing out weak entities from auto manufacturers to home lenders to investment banks (as lender/capital provider of last resort); the government's own balance sheet starts to weaken. We are seeing this type of action not only in the US but elsewhere. The Bank of England embarked on 'quantitative easing', in other words, printing money, well before the Fed.

The Australian government has announced a series of fiscal policy measures and the RBA has lowered the cash rate by a whopping 4.25% in 6 months to boost the economy. Spend, spend, spend, is the new mantra! The economic stimulus measures, combined with reduced tax revenue as companies feel the pinch of the contracting economy, have resulted in huge fiscal consequences. The Government in Australia in recent years has enjoyed a healthy budget surplus. This has quickly turned into a very large deficit (from positive A\$20 billion to negative A\$80 billion in just one year).

## **2. Future inflation is looming – back to the 1970s**

Bailing out the excesses of leverage in the housing markets and financial sector, by printing money and asking citizens to leverage up even more, has long term consequences. The market has started to anticipate that such a massive bailout is highly inflationary for the future. Hence, longer dated securities demand higher rates. Would any rational investor fund the US government over the next 10 years at 3.15%? You would do so only if you believe that we are headed in a deflationary world. If that is the case, kiss your equity returns good bye!

## **3. The world's economic problems are getting fixed**

When economies slow down, equity markets suffer, rates drop, and bonds produce positive returns. Over the long run, neutral rates are not at zero in the US and 3% in Australia, they are closer to 5%. As the markets anticipate that the economy is bottoming out (remember the equity market is usually ahead of the central bankers by at least 6 to 9 months), bond markets start to factor in normalisation of interest rates.

## **4. Risk assets are back in vogue...Bonds are on the back burner!**

When the markets anticipate the return of economic growth, risk-taking comes back. Equity markets rally, bonds sell off and riskier currencies are back on traders books. Hence, the rally in the Australian dollar from the low 60s to the current level of nearly 75 cents to the US dollar.

## **Do you believe in the equity market rally?**

We have to admit that we, like all others, are impressed by the rally in risk assets from their lows in March. We are also aware that history proves that you can get a significant bear market rally, only to drop another big leg down. Look at equities in the 1930s – the Dow rose 35% between 1929 and 1930, only to fall another 84% over the next couple years. The question is: is this a sustained long term equity rally, or are we being duped into believing the worst is over, when the market has not yet reached its nadir?

### **A few facts:**

- The problems of today started with excess valuation (housing), which lead to excess risk taking, increased leverage, and poor underwriting standards.
- The excess leverage and poor underwriting has lead to failures of over-gearred, poorly-managed companies; including mortgage originators, investment banks, automobile manufacturers, insurers and whole host of others.
- The problem was so widespread across industries and countries that it risked bringing the entire system down, hence the authorities have had to choose the lesser of two evils, ignoring 'moral hazard' (bailing out the bad boys).
- The fiscal tap has been turned on (actually flooding out of citizens' pockets). But, don't forget most governments are not in surplus; they are going from deficit to deeper deficit. Who will pay the debt back? The people will, through tax dollars and those of future generations.

*Pouring good money after bad has never been a real long term solution.*

## Take a holiday

The situation we are today is similar to having taken a holiday. Most of us that go on holiday unwind from the day-to-day stresses of our lives. We pay little attention to the cost of that bag of chips from the mini-bar, or that restaurant meal. We might even splurge on a few activities and buy a few more clothes than we truly need. We use that convenient piece of plastic – the credit card, to finance these expenses.

One could argue that most governments and investment bankers had been on holiday for the past 3 or 4 years.

Upon return from your holiday, you realise that the economy has gone into a tail spin, equity markets have collapsed, and your home value has plummeted. You also lose your job. As the credit card bills start to arrive, you wonder how you are going to keep afloat. The answer? Get more credit cards, borrow more, charge one card to pay the other – maybe even your mortgage. Temporarily, your problems go away and you open another bottle of red.

In the long run, this behaviour is unsustainable. Your house will be foreclosed, and the bill collectors will be knocking on your door. The only solution to this problem is to find a job, earn some income, spend less, save more and learn to live within your means until you are able to pay off the debt. Your standard of living has to be lower for a while.

Similarly, governments will have to tighten their belts and citizens will have to pay more taxes. The standard of living of future generations has to be lower, as they carry the burden of today's excesses.

## A decade of excesses is not solved in one quarter

Just as in the example above, a decade of excesses cannot be solved in one quarter. Central Banks have done their best to lower the burden of the cost of borrowing on its citizens. Governments are doing everything they can to inject cash into the economy. Citizens are doing everything they can to rejoice in the rebound of returns on their pension portfolios and their personal wealth.

When Ben Bernanke was referring to green shoots, we hope he meant that there were early signs that the actions taken by central banks and governments around the world to stop the catastrophic meltdown were working. **It surely did not mean that the problem was over.** It has taken hundreds of years for the California redwoods to become trees that are tall and strong (some over 400 feet high) – supported by magnificent sunshine and adequate rain. The green shoots might just be the beginning of the solution, but not a solution onto itself. This problem will take a while to fix. The green shoots are weak and vulnerable to disaster, both human and environmental. It will be many years before they can be assured of growing tall and strong, like the mighty redwoods of the California coast.

**The bigger question everybody should ask themselves is: have we solved the problem by truly changing our habits, or is this just a short term fix?**

## Now what?

Yes, the equity markets have rallied 36% in the past two months. Don't forget they have barely recovered the losses of January and February (anybody remember those months?) Don't be fooled. Despite the gain, we have not returned to sustained high returns of the past. Returns from all asset classes will be in the high single digits, at best, as we learn to live within our means!