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Issue No. 2 – October 2006

5ceans asset management

Economic management and monetary dilemmas

Significant structural re-adjustments taking place in the global economy

In our Thought Piece titled 'Underlying dynamics of the global economy – The backdrop to the global equity markets', we touched very briefly upon the relatively loose monetary policy and some reasons for it.

With the level of structural change taking place in globalisation, relatively easy monetary policy can be seen as facilitating that change, taking advantage of the low inflationary risk and permitting a major re-allocation of resources.

Now however there is an open point of debate. Should monetary policy have remained so accommodative across all three major economic blocks – Europe, Asia and the US? Most specifically, should rates have stayed low in the US for as long as they have?

Five Oceans' Chris Selth saw Alan Greenspan speak to this point earlier in the year. There are a number of elements to this discussion.

One is that the increasingly free flow and, what some may argue is, efficient allocation of capital, has reduced the volatility of the cycle by making supply much more flexible in responding to shifts in demand.

Policy makers had to be sensitive to the following elements when setting monetary policy:

- the presence of significant productivity improvements;
- the need to facilitate on going structural change;
- low levels of inflation;
- deflationary risk in the absence of adequate demand; and
- the capacity of China and India to significantly boost world growth potential.

The Greenspan Put[1]

Within this framework, there was a view that risks to that process will be countered by appropriate adjustments to monetary policy. This idea was embodied in the concept of the 'Greenspan put', much bandied around the market at the beginning of 2006. This of course coincided with the end of the Greenspan era[2].

This idea captures a collection of propositions. It echoed Greenspan's positive sentiment regarding the structural changes in the US and to an extent, the global economy. That view was famously telegraphed to the world first in the minutes of the Federal Reserve's Open Market Committee meeting of 20 May 1997[3]. Its essential proposition to quote Greenspan was that 'it's possible to have more sustained and higher growth without inflation than we previously thought'[4]. Greenspan expanded on these principles over the latter phase of his Fed chairmanship, whereby he saw the economy as increasingly flexible, and to an extent self regulating in the phase of economic shocks.

In one of the ironies associated with this proposition, a commonly held view has been that despite what was presented as a greater inherent stability, against that backdrop Greenspan could be trusted to adjust monetary policy appropriately to keep the economy by and large on track in that higher growth, low inflation trajectory.

This monetary policy framework has been very much associated in Australia, Britain, and the US during the Clinton era, with the idea of a disciplined fiscal position, and the transferral of the administration of elements of the public infrastructure to the private sector. This fiscal discipline further underwrote lower levels of interest rates.

And in another irony, within the context of the 'Greenspan Put' as an insurance policy, concern has mounted that it risked morale hazard. It has coincided with a contraction in risk premiums both within economies, and across the globe. This has further contracted the cost of borrowing. What we ask is has this promoted economic behaviour that was and is insufficiently cognisant of risk?

An alternate reading is that the 'put' has effectively expanded the money supply by reducing the risk premium. When combined with accommodative monetary policy it has meant a significant increase in global liquidity. That liquidity whilst it has not yet driven inflation, and indeed has underwritten increased investment in the new global industrial model, has also produced other less desirable effects. Asset prices have been bid up. Individual debt balances have risen as individuals are given incentives by low interest rates and high asset valuations to support high consumption levels, even if personal income growth for a number of groups has remained relatively modest. Low interest rates have in part reflected under-investment in necessary social and economic infrastructure, promoting short-term consumption over long-term investment.

A number of the investment projects in China, India and beyond are not generating returns sufficient to even meet this lower cost of capital. Private equity firms amongst others are now using cheap credit to fund the acquisition of underleveraged assets. Businesses that have been using higher levels of profitability to retire debt off their balance sheets are increasingly targets of bidders willing to take on that debt to acquire cash flows. Those cash flows are seen as relatively safe in a global macro-economic environment underwritten by the 'Greenspan put'. This style of transaction is now termed the 're-leveraging' trade, capturing the idea that un-geared balance sheets are particularly inefficient in a period of secure growth and low interest rates. Re-leveraging gives those investors access to immediate capital gains.

The consequence of extended cheap funding may be an undisciplined allocation of capital. Its consequences may have been masked by the dis-inflationary impact of China and India, and the related competitive environment that has disciplined the operation of businesses in the real economy.

Alan Greenspan's view?

For what it's worth, Alan Greenspan was asked his view on this phenomenon at a conference Five Oceans' Chris Selth attended in Tokyo, though the expression 'Greenspan put' was not explicitly used.

His reply, and we radically paraphrase, was 'what was the alternative?'

In the absence of inflationary signals a tighter monetary policy setting may have risked a deflationary spiral as was seen in Japan. Further, he suggested that it was naive to think that monetary policy settings could singularly eliminate cycles. To an extent the economy had to be left free to direct capital as it chose, and needed to understand that there would be times when there would be excess investment and consequent correction phases.

He moved on from the implied issue of the Greenspan put, and noted that his concern for the world economy lay in energy prices. This is an important question which touches on the dilemma currently confronting policy makers and investors alike. The question is, what is the sustainable level of world growth? In this instance we use the idea of sustainability with reference to NAIRU, a piece of economist jargon meaning the Non Accelerating Inflation Rate of Unemployment. i.e. how fast can we grow without spurring an accelerating rate of inflation? The behaviour of energy prices, commodity prices, particularly in the face of high growth in both the US and China, has suggested that the low inflation era may now be reaching a testing point, if not an end.[5]

Consequences: Does the goldilocks scenario[6] risk being eaten up by the three (or more) bears?

US imbalances

The situation may have been further exacerbated by a number of elements of US government policy. The Iraq war coincided with a change in taxation policy which was, in part, justified by concerns about slowdown post-Sept 11, and the weak job creation prior to the last presidential election. This collection of forces sees the US with significant imbalances, in terms of private debt balances, the balance of payments and the budget deficit.

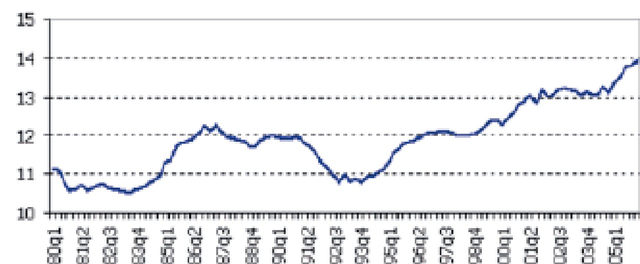
These imbalances are a topic of endless discussion. The issues involved are:

1. What is the significance of the US trade deficit? Many of the exports entering the US are by US companies outside the US. To an extent the trade flows represent a reorientation of the global supply chain.

   New US Fed Chair Ben Bernanke has argued that America's deficit is the result of a savings glut in the developing world and as such is more sustainable than some would think.

2. To what extent is the US consumer over-extended? The question is not the size of debt balances in absolute terms, but rather the capacity of the consumer to service that debt. What percentage of income streams does debt servicing represent? The chart below shows the US debt service ratio at around 14% at the beginning of 2005 – the highest level in 25 years. Of course if there is an inflationary resurgence driving up interest rates it will make the debt service problem significantly more challenging.

US Household Debt Service Ratio as a % of Income



Source: The Federal Reserve Board

3. What is the direction and significance of the US budget deficit? Improved taxation receipts are beginning to positively impact this position, but will this be sufficient? There has been a surge in corporate tax payments with the strength of the economy.

4. US private consumption trends – the role of business investment driving consumption patterns post the peak in household consumption.

At present the scenario that would seem reasonable to forecast is that US growth is likely to decelerate under the impact of higher interest rates and oil prices. These two factors will impact debt servicing costs and discretionary income. To this end the US housing sector is highly exposed.

Some positive offsets should eventuate out of the acceleration in corporate capital expenditure as certain reinvestment cycles are set in train. On the assumption that world growth stays above certain levels, US companies should benefit, particularly if the US dollar weakens marginally, supporting those investment levels.

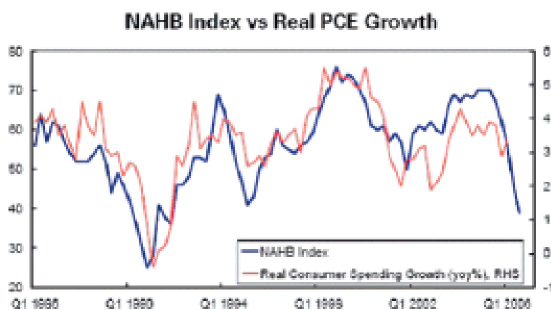
The question becomes: where will those higher interest rate levels sit, and what is a sustainable level of growth and consumption at those levels? Will the US economy move to this new vector smoothly (soft landing) or through some cathartic process (hard landing)?

The sector that is viewed as problematic is US housing. We have been focusing on this area as a problem area, but one that is priced as such, and might offer opportunity given supportive demographic drivers.

The NAHB Index which measures builder sentiment and has an 83% correlation with new home sales in the US is currently at an 11 year low.

The nexus between US housing and consumer spending

NAHB points to US consumer slowdown



Source: DB Global Markets Research, Bloomberg

One key element in considering the likelihood of these two scenarios, hard landing versus soft landing, is the extent to which we are witnessing the return of inflationary forces.

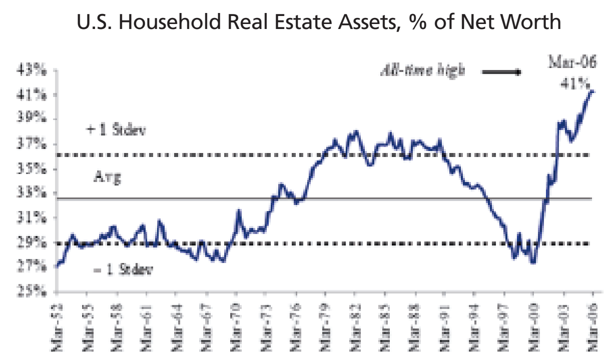
The return of inflationary forces

Whilst manufacturing prices have remained depressed in this high liquidity environment there have been numerous areas where prices have not been so well behaved.

In commodities, real estate, financial assets and certain parts of the service sector, prices have increased. How should we consider these price increases? Are they 'inflation'? Despite high levels of liquidity, standard measures had not until recently been measuring increased inflation. However in July 2006 core US inflation registered at 2.5% above the 1-2% range targeted by the Fed.

Real Estate has boosted the net worth of many Americans

U.S. Household Real Estate Assets, % of Net Worth



Source: Federal Reserve Board, Morgan Stanley Research

If these price increases are caused by inflation, traditional monetarist dogma characterises monetarist inflation as always a monetary phenomenon. The Austrian School of Economics defines inflation in slightly different terms, it is 'an inflation of the supply of money.'[7] All other things being equal, inflation can be expected to cause an increase in prices, but exactly which prices are affected when and by how much will depend on how the newly created money was introduced to the system, and how the new money spreads throughout the economy. Therefore, in the Austrian view, it is possible that changes in productivity (or other factors) will drive down the price of any arbitrarily chosen basket of goods, even in the presence of inflation (of the money supply). Thus fighting inflation is very simple in the Austrian framework: just stop creating new money. Increasing prices can have many causes, and inflation (of the money supply) is but one.

It is intriguing that this is consistent with a Post Keynesian view of inflation, picking up classical economic traditions, seeing inflation as in part a struggle regarding income distribution. The current economic environment has seen a significant shift, if not in wage income distribution, in asset wealth distribution. So in the Austrian analysis owners of capital assets, strong

commercial distribution franchises and scarce intellectual property have seen the value of those assets bid up, whilst the providers of labour have seen the relative value of that labour decline in the new global labour market.

According to most monetarists, government action is at the root of inflation[8] and certainly the US Federal Reserve is highly aware of the complexities of this situation. This probably means that they will act with a degree of circumspection, as has been shown in their recent pause in increasing interest rates, regarding the risk that they over tighten and precipitate a hard landing. However if energy prices climb further and the bond market inflation vigilantes get concerned the hand of the Fed could be forced.

The baton change to Bernanke

Earlier this year Ben Bernanke replaced Alan Greenspan as Chairman of the US Federal Reserve. Around this time the Economist ran a front cover showing Greenspan passing the baton to Bernanke as if in a relay race, except in this case the baton was a burning stick of dynamite.

The general view is that under Greenspan's 18 year reign the US economy was able to consistently grow, notwithstanding a series of crises including Long Term Capital[9], September 11 and the Asian crisis of 1997. Greenspan's steady hand on the 'monetary' tiller has enabled the US to prosper from one of the longest extended periods of economic growth in its history.

Today we are faced with evidence of a slowing US economy and rising inflation. As previously stated, in August the Fed decided against a further rate rise and held rates steady after 17 consecutive interest rate hikes.[10] The quandary now is if the Federal Reserve raises rates too aggressively the economy risks falling into recession while if they leave rates on hold they risk seeing inflation re-emerge and some of the imbalances, increased household debt and negative savings rates, fail to get back into line.

It is interesting that the concept of the Central Bank's independence is tested when there is a transition between Fed Chairs, as it is during this period that the President gets to elect the new overseer and thereby put his political mark on the process. With the Republicans in trouble politically it would be expected that Bush would tip towards a new Fed Chair who would best ensure the economic wheels stay firmly attached through to the next Presidential election.

What are the early signals regarding Ben Bernanke and his style? Bernanke is a former Chairman of Bush's Council of Economic advisors, a onetime Fed governor and a former Chairman of Princeton's Economics Department.

In a world where the markets hang off every Fed Chairman's words, there is a feeling that Bernanke may be crisper and more concise in his delivery than Greenspan was with his more long winded explanations. However, he has already learnt a lesson in this regard, when his dinner discussion with a fellow diner regarding previous public statements was leaked out and sent markets in a flutter.

Will Bernanke follow the course set by Greenspan or will he branch off into a new direction? Will he continue to be hard on inflation as were Volker and Greenspan? Is the Greenspan put still alive and well? It appears too early to tell but certainly the new Fed Chair is immediately being tested as the economic messages presently are ambiguous and in this environment any mistakes with policy could have grave consequences.

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Notes

[1] The 'Greenspan put' is defined as 'A description of the perceived attempt of then-chairman of the Federal Reserve Board, Alan Greenspan of propping up the securities markets by lowering interest rates and thereby helping money flow into the markets. Investors assumed that they would be able to liquidate their stocks at a set price at or before a future date as if there was a built-in put option. They believed that Greenspan would manipulate monetary policy and continue to maintain market stability. http://www.investopedia.com/terms/g/greenspanput.asp

[2] On 1 February 2006, Ben Bernanke replaced Alan Greenspan as the US Federal Reserve Board Chairman.

[3] http://www.federalreserveonline.org/

[4] A quote given to Business Week on July 2 1997, referred to in article 'Alan Greenspan's Brave New World.' http://www.businessweek.com/1997/28/b35351.htm

[5] For what it's worth, Greenspan characterised his view of energy markets in terms of market inefficiencies. He felt that supply had been driven by non-economic forces, and that the price mechanism had not produced an adequate supply response in the face of increasing global growth. This is a complex discussion that is worthy of consideration. There are a collection of inter-related issues here. Has world growth been stimulated by low prices of energy? Prices that may not have adequately reflected the potential risks of 'peak' oil, or as a significant aside excessive carbon emission? Or is it that supply has been constrained by both regulatory intervention and corporate profit maximising strategies constraining investment? This discussion is of course immensely contentious. We look at some of the issues in our Thought Piece on 'Peak Oil'.

[6] Not too hot, not too cold, like good porridge. The Goldilocks Scenario is commonly characterised as good economic growth with low inflation.

[7] http://en.wikipedia.org/wiki/Inflation#Austrian_economics

[8] http://en.wikipedia.org/wiki/Monetarism

[9] http://en.wikipedia.org/wiki/Long-Term_Capital_Management demise folded in 1998 and lost US$4.6 billion in less than 4 months. http://en.wikipedia.org/wiki/When_Genius_Failed:_The_Rise_and_Fall_of_Long-Term_Capital_Management 'Prompted by deep concerns about LTCM's thousands of derivative contracts, in order to avoid a panic by banks and investors worldwide, the Federal Reserve Bank of New York had to step in and organize a bailout with the various major banks at risk.'

[10] Janet Yellen, President and CEO of the Federal Reserve Bank of San Francisco explains why the Fed pauses in its raising of interest rates in Aug 06 in her article at http://www.frbsf.org/news/speeches/2006/0907.html by Janet L. Yellen, 'Prospects for the U.S. Economy'

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