FIVE OCEANS ASSET MANAGEMENT

Cycles, Speed Bumps and the Road Ahead

As the global economic system continues to operate under significant stress, lead indicators of global growth deteriorate and inflationary pressures escalate, the key question remains. Has the market effectively discounted this newsflow? The analogy put to us by a senior investment banker which we believe best captures the dynamics of the period is 'the eye of the storm.' It's evident that the ultimate scope of the current dislocations are still playing out.

The Shape of the Cycle

Notwithstanding equity market valuations are now seen as supportive on a historic basis, significant challenges continue to lie ahead. If one considers the work of the more bullish strategists as capturing the shift in thinking, equity markets have been hoping that we would shift to a more traditional economic cycle. Fed easing would restart economic activity after a slowdown. After surviving what felt like a near death experience with Bear Stearns, a hope grew that the worst might have been passed. Equity markets have nervously sought to understand the trajectory of an economic recovery. Yet this process is made nigh on impossible by the fact that the scope of the crisis is not yet fully understood or felt. To try to dimension a recovery may be premature given the exact nature of the downturn is still unclear.

Speed Bumps and Global Inflation

Global economic development has been driven by a productivity revolution, under-utilised productive resources were mobilised in Asia, organised by a global 'neural network' constructed with new technologies and fueled by readily available credit. But what were the speed limits of that system? Classically as an economy speeds towards its limits, the finite nature of resources makes itself felt through rising prices constraining growth. Interest rates rise driven by markets echoing the risk of inflation, and central banks attempting to reduce overheating posed by excess liquidity.

But this cycle has been marked up until now by the absence of these classical speed limits. The world has grown above trend for several years with prices of many goods actually falling. China has grown at double digit rates. That has demonstrated that real productivity gains were being accrued.

But prices are now rising. It's all very simple. We just forgot the rules of the game. It was a great party, but now its over. But the better the party the more painful the hangover can be. The party saw returns on capital rise, profit share rise, but investment in system level infrastructure did not match the needs placed on it by this rate of accelerated change. Whether or not there are ultimately available reserves of oil, or other raw materials, supply curves are not sufficiently flexible in the short term to meet the massive growth in demand that has been experienced, especially with fuel subsidies in place. Furthermore relative declines in wages have been matched by a similar relative decline in investment in agriculture.

Recently we were in Shanghai where we found it amazing to hear Asian based fund managers complain that the increase in commodity prices was driven by speculators. The boom in the Shanghai equity market to high multiples on an earnings base inflated by asset trading gains however was not seen as speculative. Asian growth was the inevitable given. Input price inflation as a result of an overheated economy was a false signal. This is clearly madness.

In fact many market participants positioned themselves in May for the necessity if not the inevitability of a commodity price correction, or more specifically an oil price correction. Of course, in classic repeat of the common pattern it did not happen as everyone was positioned on the same side. As we moved to the end of the month and into June this trade was violently shaken out.

The problem is that the global growth drivers, where credit underwrote both the industrialisation of Asia and the sale of that output to consumers in the West, has hit its speed bump. The capacity of the Fed to cut rates is significantly negatively impacted by this fact. The virtuous cycle of global growth and price decline has been inverted.

The Feds Dilemma

Further to this we are talking to a new type of inflation, one that is not well understood by market participants. Inflation is of course a complex phenomenon. The current 'inflationary situation' is marked by a few particular dynamics that need to be understood. Firstly, at present, we are in what can be called the 'Keynesian' stage of relative factor prices. Commodity prices, agricultural prices, and labour costs in Asia must all rise if this growth is sustained. Note that food riots in parts of Asia cannot be controlled by wage discipline. Low income earners cannot absorb increases in the prices of necessities. At the same time economic observers in the US note that these price increases represent a smaller part of US consumer price baskets.

What this tells us is that ultimately for inflation not to move up price increases in commodities, food, and imported goods might be offset be declining prices elsewhere. This is why even though central bankers might not yet see increases in 'core inflation' that excludes food and energy, they need to keep both 'headline' and 'core' inflation down. This means they may need to keep tighter monetary policy than would otherwise be the case in order to control price rises in these other parts of the economy from rising to compensate for higher imported prices.

This leaves the Fed in a politically brutal situation in the presence of housing price deflation. Tight monetary policy in effect may stop inflation but it will lock in an element of the wealth transfer away from Western consumers and banks to Asia.

Alternatively the system requires that Asian growth decelerates in order that inflationary pressure decreases, most explicitly expressed in the oil price. The market is beginning to understand this and is beginning to discount earnings accordingly. But how will the next cycle manifest itself? The downturn must manifest before any fall in interest rates becomes credible. The recent drop in rates by the Fed sits in a position of tension. Its attempt to shore up the US economy in the face of the housing downturn sits in contrast to the need to decelerate global growth.

The very virtues of this economic cycle, as is always the case, have bred the complacency and excess that are triggering this downturn. Within the speed bump lies the classic air-pocket formed by excessive debt balances in parts of the economy, with the consumer and the banking system.

Playing for the Break!

Classically now falling interest rates would see the market move from a bear phase, discounting an economic downturn, to a new bull phase discounting the recovery. Market leadership would be taken by financials as a steepening yield curve would see interest spreads widen boosting financials earnings whilst late cycle stocks such as capital goods companies would still be experiencing earnings declines as business pulls back its investment. But we are still working through the credit write-offs as the system works out its excesses. Bad debts, first seen in residential property, are now rising in commercial property. Loans to business will be next, though in this cycle corporate debt balances are relatively low. Until this phase is worked through, shares in financials will struggle to sustain any rally.

As such the market is trapped as confidence declines in late cycle stocks, but cannot be built in early cycle stocks such as financials. Hope for the rebound, born in March at the point of Fed intervention in Bear Stearns, has now faced the brutal reality check we expected.

The Goldilocks economy now finds itself come to earth with a bump, with what looks like a classic cycle formation. If old patterns reassert the US economy will be the first to decline and the first to recover. Europe and Asia are now set for their declines. European interest rate policy makes this outcome almost inevitable. But this will take some time to play out. The rebuilding of US savings levels will need work. And the impact of the significant structural changes in the world economy will mean the shape of the new cycle may not resemble the past.

Against this sits another point of irony. Late cycle capital goods expenditure should roll over, but in order to reduce inflation and de-bottleneck long cycle infrastructure investment must be sustained. As a result business activity will need to be sustained and supported in several important areas, yet interest rates are likely to rise.

We are witnessing such investment in a range of areas, from commodities to communication. The technology space is in part being driven by the growing awareness that investment in the communications space is underwritten and sustainable over the current period. Mobile broadband is upon us. Telecom carriers are now beginning to position themselves for this next phase. Intel, which has long wanted and needed to penetrate this space, announced with much fanfare a new chip architecture whereby it inverted the focus of its technological prowess from more computing power to less power consumption.

With the backing of major PC makers cheap 'netbook' consumer platforms are flags as to the expectations of a major product cycle of mobile net access devices. Of course Apple's iPhone is the highest profile, but hardly unique representative of this.

Financials

In the banking sector we have wondered at the sanguine manner in which the market had absorbed calls on capital and looked for evidence that this has somehow marked the bottom! Post the Bear Stearns crisis and the Fed's interventions financials continue to fathom the stark reality of the major credit costs to be faced. These may be partially offset by some write-backs on securities portfolios, but the nature of the size of the coming credit deterioration is yet to be seen.

In summary, until we can gain more clarity and can better dimension these issues we will continue to position the portfolio on the basis that we are in the middle of a bear market.

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