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The great anomaly today is the combination of reasonable financial stability in an environment of substantial economic imbalances. The world looks so fragile and dangerous, yet financial and economic stability has so far been maintained, and assets have performed tremendously well.

Today's piece, taken from the author's monthly letter to investors, not only provides a glimpse into Hugh's thought process and portfolio structure. It also helps place this odd environment in a historical context. He points out how large economic imbalances have, in past circumstances, typically been supported by liquidity provision. This, in turn, generated extreme behavior in asset markets, with booms followed by busts when the liquidity tap was turned off. The controversial part of his piece, which I examine in a post-piece comment, is the role of interest rates and Treasury bonds during the adjustment process. - Andres Drobny

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Trees Don't Grow to the Sky

Hugh Hendry

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Our favoured bull markets have been under sustained attack since the end of January: the gold & silver index is off more than 20%, oil services 16%. If I were philosophical, I could argue, so what? The stock price of Cisco suffered periodic declines of between 20% and 40% between 1997 and 1999, and yet the stock was a 10 bagger.

Markets are malicious and winning means riding the 'bucking-bronco'. So, one reaction is: don't worry: we have invested in a series of asset classes (Japan, gold, energy, music publishing, uranium) that are now in early stage bull markets. Their bear markets were long and devastating, their future, by comparison, should prove benevolent.

However, I'm a worrier, always have been, always will be, and something is unsettling me. Personally, I blame the historian C. Quigley. His book, "Tragedy & Hope", asserts that liquidity in the 1920s "permitted the world to live in a fairyland of self delusion remote from economic reality".

WW1 created disequilibrium, bequeathing to the US the uncommon legacy of being both a creditor nation and net exporter. Such a combination is not sustainable in the long term. This is one of those fallacies of composition arguments.

Trees don't grow to the sky, and overseas debts have to be made good by running larger trade surpluses. The creditor nation must import more. But in the 1920s the US resisted. Trade tariffs were the norm and an indebted Europe was mollified by generous American lending. International tension was relieved by an abundance of liquidity which allowed stock prices to grow to the sky. And then they crashed.

Whilst rare, the creditor/exporter nation status has continued to define financial disequilibria. Japan's sizeable surpluses in the 1980s explains the central bank interventions of Plaza and Louvre.

Unlike the 1920s, the creditor nation (Japan) displayed willingness to be a cooperative member of the international community. It allowed its currency to rise, to stymie its exports, and it cut interest rates to boost its domestic consumption of imports. But again the political fudge of monetary accommodation sent Japanese share and land prices to the sky. And then they crashed.

Accordingly, it is troubling how the rise of China today fits the pattern of the US in the 1920s and Japan in the 1980s: a creditor, export nation soothing its trading partners with the balm of generous overseas loans. The Chinese currency should rise and thereby mitigate the trade tension.

Instead the currency is fixed and its principal trading partner, the US, has been subdued by the purchase of a trillion USDs of Treasury bonds. Liquidity has been unleashed once more and disequilibrium has become the norm. Stock markets are again ascending into the sky. Will they crash?

Historians might chart the beginning of any demise to last October when the Lowry system captured its first day of panic in 3 years and when selling pressure on the NYSE overtook buying power. Whilst the Dow proceeded to make a 5 year high on the 16th of February this year, only 4 stocks recorded highs; 50% of the index was off at least 20%.

The market advances with fewer participants. The average percentage of NYSE stocks making new highs at market tops for the 1929-2000 period was just 17%. Today's percentage (14%) is eerily similar. The bulls have yet to explain why the path ahead is becoming so narrow when bulging profits and the prospect of takeovers supposedly make the market so compelling; or is it really a fairyland of self delusion remote from economic reality?

Finally, in 1927, the French, like their modern Chinese counterparts, insisted on reflating their economy via an undervalued exchange rate. Exports blossomed and the resulting trade flows were met by unsterilised Franc selling by the Bank of France; FX reserves swelled considerably in order to suppress the external value of the currency.

Like China today, where reserves amount to 37% of nominal GDP, these balances reached an uncomfortable level. The French opted to convert their paper into gold. Fearing the contractionary implications for the US banking sector, the Fed reduced domestic interest rates. Like Japan in the 1980s, such easing was entirely unsuitable for the domestic economy and in 1928 the Dow went parabolic.

It is our conjecture that something similar could happen in the future, i.e., that the Chinese could swap their paper reserves for hard assets like precious metals and oil whose price could turn parabolic. We think the Fed will have no option but to accommodate such Treasury sales by unsterilised intervention – Bernanke's much vaunted printing presses - which would unseat the dollar.

Accordingly we have been supremely bullish of all things commodity related and they have been the best asset class of the last 5 years. Indeed, in the vernacular of Don Coxe, and his triple waterfalls, this should endure: for the last 3 decades, whichever asset class does best or worst in the first half of the decade, has the same performance in the second half. Nevertheless, first, we see a curve ball ahead.

Excitement for physical assets, whilst merited, is most definitely passé when Antofagasta, the Chilean copper mine, Suncor Energy, the oil-sands phenomenon and Cameco, the uranium miner, have all been 10 baggers since 1998. Rather, with interest rates having been increased 14 times already in the States, and the habit spreading internationally, we believe a tipping point could be at hand for the global economy which could precipitate a slowdown.

Our message continues to be: fear inflation, buy US Treasuries! This might provide us the leeway to put a lot of money into commodities at prices lower than today. Gold selling for $850 in 1980 was an absurd reality, treasuries selling above $135 in 2006/7 would likewise seem silly but it remains within the bounds of reason.

So where are we? As we said in the first paragraph, good things happen in bull markets and we have therefore retained a diminished position in the bull markets of gold, energy, Japan et al; in our inflation bets. We remain skittish however of overall market prices and have retained a long volatility position and some directional shorts, such as Persimmon, the British house builder. And, finally, we have a foot firmly in the deflationary correction camp with shorts in copper futures and mining equities and a modest long position in US Treasuries.

Consider that historically, companies would fire people only to find their cost reduction undone by falling revenues as consumers saved more; profits and the economy would prove cyclical. But not today. Bolstered by the Chinese determination to control the price of their currency, the bankers of Asia have created the proverbial wall of money that fortifies asset prices everywhere. Who needs savings when credit is so plentiful and asset prices are rising? Last year, for the first time since 1933, Americans spent more than they earned. Lower corporate costs combined with top-line expansion to create a profit bonanza. Investors and corporate managements are ecstatic.

Trees do grow to the sky after all! And then do they crash?

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Andres Drobny comments: The model described by Hugh is akin to one that I think several (successful!) macro managers have been pursuing. The idea is to be long assets where supply is sufficiently inelastic (eg, especially some commodities), and long Treasuries against this. A softening of US growth could reduce underlying demand for supply constrained assets, hence threatening their price.

It might work, yet Treasuries may not be the best instrument to buy. The savings short/borrowing country in the model needs higher rates, not lower rates. If US demand growth has been excessive, then to assume the economy will simply roll over, with rates still very low, seems hopeful.

Perhaps, it’s just the opposite. Higher US rates and lower Treasury prices may be what is needed to eventually stem excess US growth and potentially unbounded asset appreciation.

If that’s correct, then the better combo is long assets (and long asset volatility) against short Treasuries! The 1987 model. The idea here is that US yields have to rise until they reach a point where assets start to give.

And, this combo actually fits the scenario described by Hugh, when the Chinese ‘swap’ paper for real assets. His ‘swap’ of paper really means ‘sell’. The Bernanke helicopter drop he alludes to would come after the Chinese sale. Treasuries first sell-off, before they can recover. It’s not a bullish case for Treasuries, though it is a bearish story for the USD.

And, that also means that, even if Hugh’s model proves perfectly accurate, Treasuries would likely be the wrong bond market to own. It would be overseas bond markets that should do best. A falling USD exports deflation from the US to abroad. Especially if the FED once again take aggressive action to cushion US growth, thus limiting the extent of any unwind in global trade imbalances.

The result, in such circumstances, should be a very steep US yield curve and a lower USD. In an environment of Chinese ‘swapping’ US paper for commodities, the ensuing USD drop should result in overseas bonds, especially at the longer end of the curve, outperforming US Treasuries.

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