

## Looking Back to Look Forward

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**“What’s certain is that the world is changing faster than at any time in human history and that most of us are still reluctant to step outside today’s frameworks.”**

### Introduction

What a year it has been, both politically and economically! Today, RPH Capital publishes its annual ‘*Looking Back to Look Forward*’ for 2012/2013 and, in doing so; we have reviewed the major events of this past year while giving some forecasts and predictions for 2013. Many of the events of 2012 we have noted in our past monthly commentaries and our predictions for 2013 evolve as they unfold.

We have consistently viewed economic growth as the outlier risk to our global economy. Central banks, supply chains and, of course, the global bond markets are prepared for global economic growth as stated in this December 17<sup>th</sup>, 2012 Telegraph articles written by Jeremy Warner, “... central banks risk a calamitous unwind in their economies if they move too fast. There is a paradox here. Central banks won’t know that the therapy is working until long bond yields begin to rise to reflect higher economic activity. Yet by triggering such a reaction, they threaten to undermine the very recovery they are hoping to bring about. Many advanced economies are still too heavily indebted to be able to withstand a significant rise in interest rates, [sic] bond yields, beyond present depressed levels.”<sup>1</sup>

Today’s ‘Looking Back to Look Forward’, concludes that economic and political developments, both structurally and cyclically, will make 2013 make a year of transition in which growth will surely and steadily resume, and inflation and long bond yields will start to rise.

<sup>1</sup> Philip Stephens, “State versus citizen in tomorrow’s world”. Financial Times, 14 December 2012

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## Looking Back to Look Forward

### The Past 5 years: Unbalanced Fiscal Response and Financial Repression

One of the fundamental policy errors made over the past five years is non-synchronized fiscal and monetary policy decisions. The United States has allowed easy monetary policy and fiscal policy for far too long. The US must now tighten its fiscal policy to start reducing its budget deficit, as its monetary policy is no longer effective. In Europe, the opposite is true. While Southern Europeans have gone through fiscal austerity to balance their budgets and reduce their Debt-to-GDP levels, the ECB is only now starting to employ easing monetary policies. We all now await their bond buying program to help fix the European's monetary transmission, so that all countries may benefit from low interest rates. (Southern Europeans have experienced a massive flight of capital out of their banking sector causing these banks to lend at much higher interest rates, while raising their savings rate to attract more capital.) In Europe, monetary policy has not been as helpful as it is in the United States and has not helped offset the impact of fiscal austerity.

Historically, whenever an industrialized nation has had a debt crisis, fiscal policy has supported economic growth – Past examples include the end of World War I, the Great Depression and the end of World War II. Focused austerity is not the solution to a debt crisis, economic growth is! We cannot find an example where an industrialized country used outright fiscal austerity to reduce their sovereign debt. On the contrary, fiscal austerity has led to lower economic growth, higher unemployment, a bigger budget deficit and larger Debt-to-GDP.

Financial repression is where governments or, in today's case, central banks employ measures that channel money back to themselves through such monetary policies as Quantitative Easing ('QE') to monetize their debts. In these times, governments cannot fund their deficits through traditional methods; instead they must rely upon central banks to print money. Many central banks including the US, UK, Japan, the EU and China are using such policies, resulting in their country's savers to contend with negative real interest rates; where inflation or their cost of living is higher than the nominal interest rate received from their investments.

Alternatively, for many emerging countries there has been a negative knock-on effect. Due to their high real interest rates, a flood of money from industrialized countries has arrived to capture these higher real interest rates. This has resulted in the strengthening of their currencies, substantially in some cases, and lowering of their economic growth. This in turn has resulted in their central banks having to lower their nominal interest rates to contain too much money entering their countries. As everyone can see, these repressive policy decisions are having an enormous effect globally.

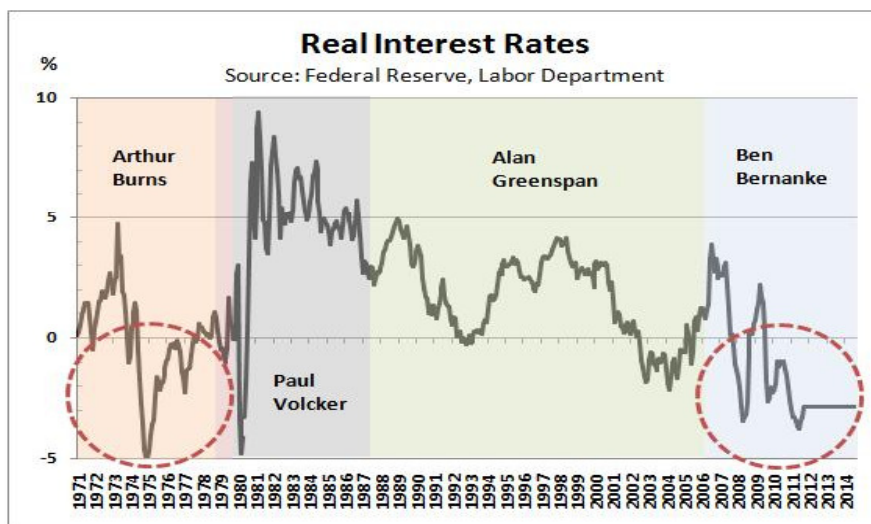
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**What is Next?**

The great economist, Hyman Minsky, demonstrated and proved that excess liquidity tends towards speculative investments, not long-term projects that add economic value. One such example in today's global economy is negative real interest rates. The below graph (Figure I), which forms part of RPH Capital's presentations, is a powerful graph showing today's negative real interest rates in the US. It displays Federal Reserve Board Chairman Arthur Burns (1970 – 1978) negative real interest rate policy, as the argument to combat a significant output gap and high unemployment rate at that time. Fed chairman Burns' negative real interest rate policy caused the inflation of the 1970's and 1980's leading to Federal Reserve Board Chairman Paul Volcker's (1979 – 1987) monetary policies to target money supply, thereby contracting the supply of money created by Mr. Burns which caused nominal interest rates and real interest rates to soar in an effort to contain and bring down inflation.

**Figure I:**



Sadly, the global economy did not learn from its past. Federal Reserve Board Chairman Alan Greenspan (1987 – 2006) again brought down real interest rates, which indeed resulted in the speculation in the US housing market; creating the housing bubble, and ultimately the credit crisis and the issues we are confronted with today. In fairness to current Federal Reserve Board Chairman Ben Bernanke (2006 – Present), he was handed a bad hand, including the lack of fiscal leadership to resolve this economic and financial crisis.

The bottom line – We again have negative real interest rates in so many global government bond markets in the industrial countries and we are about to receive another round of money printing by the Federal Reserve, Bank of Japan and European Central Bank. This will result in the emerging countries having to reduce their real interest rates even further to stop the flood of money from entering their economies (causing their currency to strengthen, killing their export competitiveness and economic growth).

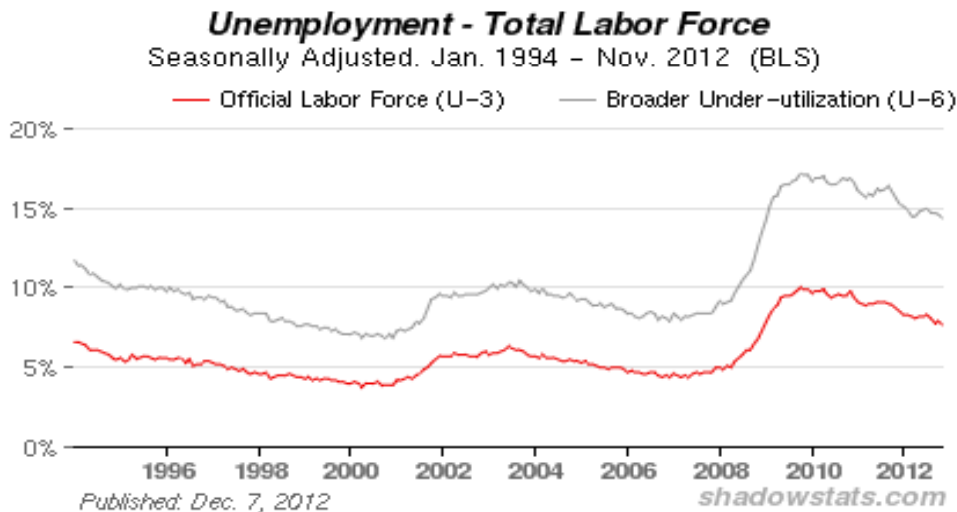
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**Looking Back to Look Forward**

One of the reasons we have negative real interest rates today is because we are making the same mistake from yesteryear. This mistake is the trade-off between unemployment and inflation, called the Philips Curve. The Philips Curve refers to the fact that the more people that are employed; the greater inflation. However, we believe this analysis is incorrect. The Fed of today is making the same mistakes as Arthur Burns' Fed by targeting the output gap or unemployment. Unfortunately, there are significant structural problems for so many countries in the West that cannot be solved through easier monetary policies such as printing money or QE. As previously discussed, there is an employment mismatch in western economies where millions of jobs are available; however the required training or education to fill these opportunities is not available. To solve these problems, we require fiscal leadership *not* printing more money from central banks.

The below graph is from Shadowstats.com describing the unemployment rate in the United States going back to Fed Chairman Alan Greenspan's era. At school, we were taught that the non-accelerating inflation rate of unemployment (NAIRU), which refers to the level of unemployment, does not trigger rising inflationary pressures. We were taught that this level should be around 6% in the US. Mr. Greenspan decided, based on his assumptions, that the United States had entered a new paradigm shift, and therefore the basic assumptions of NAIRU should be ignored. Therefore, he allowed the unemployment rate to fall to 4% while not raising interest rates. As they say, the rest is history.

**Figure II:**



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### Monetary Policy Today

Now, back to present day 2013, where central banks continue to announce more and more stimulus and easy monetary policies. These policies have become a drug addiction and the central banks do not seem to be able to stop!

The Federal Reserve announced more Quantitative Easing for 2013, whereby they will print \$85 billion each month adding a further \$1 trillion of additional printed money and excess liquidity into the US economy and global financial markets. \$40 billion will be used each month to buy US Treasury bonds.

In the UK, Chancellor of the Exchequer, George Osborne, has come out and said that the Bank of England should abandon inflation targeting and use economic growth (GDP), thereby opening the door for more expansive monetary policy.

The recent Japanese election returning Liberal Democratic Party leader Shinzo Abe to power has promised to boost the economy with a surge in spending and to push the Bank of Japan to adopt a more aggressive monetary easing to curb deflation.

The European Central Bank ('ECB') is readying herself to buy bonds and ultimately print money.

And, the Peoples Bank of China (PBOC) is also injecting credit and performing financial repression as they try to stimulate their consumers and maintain export competitiveness.

These are all profound policies and have unintended consequences. Just ask the Brazilians, the Australians, the Israelis, and so many other countries who have been caught in the middle of global financial repression. These countries have to lower interest rates to weaken their currencies resulting in a tsunami of inflation bombarding their economies.

Many economists argue that monetary policy will remain unchanged as the economy goes sideways at best, while inflation will remain under control and long bond interest rates will move sideways. We take quite an opposite view based on a thorough analysis of cyclical and structural economic developments. We take into consideration the bond markets technical aspects, in other words demand and supply of long bond issuance. We believe that inflation and long bond interest rates will start to rise in earnest.

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### Underlying Forces for Rising Interest Rates

As a global government bond investment manager, we are continuously looking at the fiscal state of a country and the structural differences between industrial and emerging economies. We view this information through their annual budget deficits, annual refunding requirements and dependency on foreign capital to fund their deficits.

For those industrial countries that have a high Debt-to-GDP ratio and require foreign investors to fund their deficits; there are much greater risks for rising interest rates.

For example, the United States must refund 27.3% of their GDP in 2013, while Italy has a similar fate having to refund 25.3%. However, Italy has been cutting their budget deficit by running a primary surplus, which will reduce their indebtedness over time. This is depicted in the below table (Figure III) where Italy's total financing levels are lowering from 2012 to 2013. The reverse is true for the United States. And, do not be misled by the foreign holdings statistic for the United States, it is markedly reduced by the holdings of US Treasuries by the Federal Reserve growing by 249% from \$475 billion to \$1.661 trillion, and rising! This does not include the mortgaged backed securities that the Fed has been purchasing at a rate of \$45 billion per month. The Federal Reserve is now buying 80% of all bonds being issued by the US Treasury Department.

**Figure III – This table lists the gross financing needs from selected countries <sup>2</sup>:**

Country	2012 <sup>3</sup>				2013			
	Maturing Debt	Budget Deficit	Primary Balance <sup>4</sup>	Total Financing Needs	Maturing Debt	Budget Deficit	Total Financing Needs	Gov't Debt Held by Foreign Investors
Japan	49.3	10.0	-9.0	59.4	51.3	9.1	60.4	18
United Kingdom	6.9	8.2	-5.6	15.1	7.4	7.3	14.7	28
Italy	27.4	2.7	2.6	30.1	23.5	1.8	25.3	46
Germany	8.1	0.4	1.4	8.5	7.9	0.4	8.3	51
United States	17.6	8.7	-6.5	26.3	20.0	7.3	27.3	32

<sup>2</sup> Fiscal Monitor, IMF, October 2012, Page 29

<sup>3</sup> All numbers are in percentage of GDP

<sup>4</sup> Excludes interest payments on government debt

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So, why are these central banks continuing to monetize their annual fiscal debts? Because they feel they have no choice. If they do not buy these bonds at these negative real interest rates, then who will? If they do not buy these bonds, then real interest rates will have to rise to a level where they are attractive to both domestic and international bond investors. But it is highly questionable if they will be able to control the long end of the curve. It is for this reason that we believe that the UK and the US are the two countries government bond markets that will be under enormous pressure as growth and inflation start to rise. We believe it is very likely that yields will rise, and rise soon!

We also expect German Bund yields to rise, however the Anglo-Saxon bond markets offer a much better short return-on-investments. Also the government bond instruments available in the US and UK are better for shorting and capturing the rising real yield value by using 30-year zero coupon bonds in the US and taking advantage of the overvaluation of UK inflation-linked bonds. Additionally, as explained previously, monetary policy in these two countries have run their course, while fiscal policy and political leadership are needed in the US to resolve their employment problem and have economic growth.

The below table (Figure IV) shows the gross Debt-to-GDP of four industrial countries and three emerging countries, along with their fiscal revenues and expenditures, as a percentage of GDP <sup>5</sup>.

**Figure IV:**

Country	2012 Gross Debt-to-GDP	2013 Gross Debt-to-GDP	2012 Fiscal Revenue	2013 Fiscal Revenue	2012 Fiscal Expenditure	2013 Fiscal Expenditure
Japan	236.6	245.0	31.1	31.5	41.1	40.6
United Kingdom	88.7	93.3	37.2	37.1	45.5	44.4
Italy	126.3	127.8	48.3	48.8	51.0	50.6
Germany	83.0	81.5	44.5	44.4	44.9	44.8
United States	107.2	111.7	32.0	33.2	40.6	40.5
Brazil	64.1	61.2	35.1	35.3	37.3	36.9
Mexico	43.1	43.2	23.2	23.3	25.6	25.3
China	22.2	19.6	23.2	23.3	24.5	24.3

Industrial countries are labored with debt. They have to raise more revenue to fund their deficits as their fiscal spending is nearly 50% of their GDP. Alternatively, looking at the emerging middle class economies, they have very little debt and are living within their means creating new middle class citizens, while the industrial countries are bloated with debt and contracting purchasing power reducing the living standards of their middle class consumers.

<sup>5</sup> Fiscal Monitor, IMF, October 2012, Appendices

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**Economic Growth is Being Underestimated**

Most investors are missing the power of the new emerging middle classes in countries outside of the industrialized countries. The cost of delivering goods to market from Asia to the North America is changing; a manufacturing renaissance on the North American continent is emerging, coupled with energy independence is resulting in a huge game changer. Also, the difference between previous economic recoveries and this recovery, in the industrial countries, is that economic growth is coming from the emerging world. Trade flows are changing and their contribution to global growth has risen from 35% to 70% over a mere 5 years ago. Today, emerging economies represent 40% of global consumption from 15% in 2002, while the United States represents 25% of global consumption, down from 35% in 2002.

The key economic statistic that one uses to ascertain whether the economy is starting to pick and grow is money velocity; the speed in at money flows through the economic system and the average frequency with which a unit of money is spent on new goods and services. Broad money supply is the best measurement. The German Bundesbank used to target M4 money supply as their target for raising or lowering interest rates and managing the credit supply to the German economy. Before the European Central Bank, the Bundesbank was the most credible and influential central bank before the creation of the Euro single currency. Broad money supply was their single target, whereas other central banks used inflation or employment, or a combination of the two. Then, Fed Chairman Alan Greenspan chose to ignore broad money supply as an indicator for economic growth. However, thanks to Shadowstats.com they have kept up the M3 money supply series in the below chart (Figure V). As described in the table, money supply has contracted since the end of the Great Recession and has been moving upwards. It has certainly not recovered but is expanding nevertheless. It tells us there are signs for future economic growth in the United States.

Figure V:



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### Predictions 2013

2013 will be the year where we see market forces prevail. Indeed, monetizing the debt in the United States and other countries will continue, however as economic growth picks up and inflation increases in middle class America, there will be a flight out of bonds causing interest rates to rise. As discussed earlier, the difference today than previous recoveries is the expanding middle classes in the emerging countries, the employment mismatch in the industrialized countries causing labour shortages and higher labour costs, and central banks printing money ensuring that inflation will be coming back with a vengeance. Monetary policy can keep short term interest rates locked down at zero, but longer dated bonds cannot be kept down forever – Market forces will prevail.

Figure VI:

Country	Real Economic Growth	Latest Inflation Rate <sup>6</sup>	2013 Inflation <sup>7</sup>	Latest 10-Year Gov't Bond Yield <sup>8</sup>	10-Year Gov't Bond Yield – June 2013	10-Year Gov't Bond Yield – Dec. 2013
United States	2.8	2.0	3.0	1.85	2.5	3.0
United Kingdom	1.5	2.7	3.5	2.05	2.7	3.2
Eurozone	0.3	2.3	3.3	1.70 <sup>9</sup>	2.0	2.1
China	8.5	3.0	3.0	N/A	N/A	N/A
Brazil	3.3	5.2	6.5	9.1	9.5	10.0
Mexico	3.5	4.0	4.1	5.4	6.0	6.5

Our global economy is on the brink of greatness due to the ever expanding middle classes in the emerging world and industrial renaissance and energy independence in North America. Unfortunately, we are held back by political uncertainty and financial repression creating investor and business uncertainty. Yet, from our vantage point, there is a generational investment opportunity.

As of our writing, the US fiscal cliff is resolved; however the politic in Washington have kicked the can down the road, again. The Republican Party in the House of Representatives will now use the legislative process to raise the debt ceiling limit of \$16.4 trillion as the point to deal with the spending issues that the US faces. As with any child it is easy to give but when one has to take away that's when the child cries and stamps his feet, pouts and misbehaves. We expect nothing less from the politicians in Washington.

<sup>6</sup> Official inflation rate

<sup>7</sup> Inflation, as measured by CPI, has been modified and adjusted over the past 5 decades representing a fraction of our actual cost-of-living

<sup>8</sup> January 3, 2013

<sup>9</sup> German Bund 10-Year bond yield

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This leads me to conclude; *“That whenever and Form of Government becomes destructive of these ends,” [sic] life, liberty and the pursuit of happiness, “it is the Right of the people to alter or abolish it, and to institute new Government, laying its foundation on such principals and organizing its powers in such form, as to them shall seem most likely to effect their Safety and Happiness.”* The Declaration of Independence, July 4, 1776.

Let’s not forget what we have always written about in the past; do not get caught in short-term reactions of incompetent politicians, such as in the Euro zone and the US Fiscal Cliff. Instead, stay focused on the long term changes taking place globally.

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### RPH Capital Investment Opportunities

So, how do we manage ourselves in 2013 in such an environment? Let's repeat our opening quote, **"What's certain is that the world is changing faster than at any time in human history and that most of us are still reluctant to step outside today's frameworks."** The industrial world is indebted to their limits, and in some cases beyond those limits, real interest rates are negative and savers are being financially crippled, while banks and governments bail themselves out. Central banks, along with commercial banks are buying their respective government bonds, and repressing and maintaining negative real interest rates. So, what happens when economic growth returns? Nominal and real interest rates will rise dramatically, and if that happens, economic growth either has to be strong enough to absorb these rising interest rates or the central banks will have to print more money to continue to add weight to their repressive policies and activities.

The key monetary statistic that will set off a warning will be money supply velocity. As economic growth picks up, money supply will explode.

Our job is to capture and create real value from investing in global government bonds. We are therefore investing in long positions where we see expanding middle class consumers, the emerging countries such as Brazil, Mexico, Israel, Australia (not an emerging country, but at the forefront of expanding Asia).

Looking at the two tables (Figures III and IV), our investment strategy will be to invest in those government bond markets where middle class expansion is creating economic growth and real interest rates are positive. Our short positions, at the moment, are in the two Anglo-Saxon countries, the US and UK, where real interest rates are very low. These countries have overwhelming debt forcing their central banks to monetize their annual deficits by printing money and holding down interest rates. This monetary policy cannot go on forever and printing money, as we have learned from history, creates inflation – Too much money chasing too few goods.

Monetary policy and QE has run its effectiveness in the US and UK. Once the Federal Reserve announced their latest round of QE for 2013, 30-year yields started to rise. To capture the negative real yield value of these two government bond markets, we will short their government bonds capturing its falling prices (rising yields), as economic growth and inflation picks up.

The International Monetary Fund has warned investors and governments that there is an asymmetric risk of bond yields rising. The Bank of International Settlements, ('BIS'), has also registered their concern that credit market spreads and yields are too low. Is anyone listening? Recently, Fitch announced that they expect "Bond Bubble carnage, as the worldwide stampede into corporate debt over the past year threatens heavy losses for investors ..." <sup>10</sup> The article concludes, "The US Federal Reserve is now holding down yields across the board that will be untenable as soon as growth picks up momentum."

We continue to predict that economic growth is the outlier risk; however we predict that this risk will become reality in 2013. We believe the United States and the North American Free Trade region (NAFTA – Canada, US and Mexico) will see a manufacturing renaissance and oil independence, which will have a massive competitive edge in production costs as energy costs in the US will be dramatically lower than Europe or Asia. We expect commodity prices to rise and inflation to become more obvious as too much money chases too few goods and commodities.

<sup>10</sup> Ambrose Evans-Pritchard, Fitch expects 'Bond Bubble' carnage when rate cycle turns," The Telegraph, 20 December 2012

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If governments can stay out of the way of human ingenuity, the economic forces of the expanding middle class consumers and the industrial renaissance in North America will create a generational investment opportunity. Investors must prepare for that day when the world returns to a more normal, albeit economically re-aligned, global economy. 2013 could be the first year we start to see all the stars to align, or re-align, providing us with those generational investment opportunities.

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