

The Pain Report

From the desk of HFA Asset Management's Jonathan Pain

Confused?

'The technical picture does look compelling as we "unwind" what was a very oversold market'

At the outset may I say I have really struggled this month to put pen to paper. Yes I am confused. But let's first review events over the last month and then we can deal with my sense of confusion. Since the last Pain Report the U.S. market did, in fact, make new lows with the S&P 500 reaching the ominous level of 666.79 on 6 March, and we have since seen a very impressive rally, with the S&P at the time of writing up about 22%. The technical picture does look compelling as we "unwind" what was a very oversold market.

Two very significant events have helped fuel the rally. First, we had the Federal Reserve embarking on the path of quantitative easing and second, the announcement of the public/private plan to purchase up to \$1 trillion of "toxic" assets from the banks. I will not say too much about the mechanics or price discovery benefits of the second plan other than to say that it is clearly a step in the right direction, and the markets would appear to agree.

In essence the Geithner Plan will help serve to remove some of the "clots" in the arterial network of the financial system. The commencement of QE (as quantitative easing is now known) by the Fed is HUGE news. In poker parlance they have played their last card but as yet are not "all in" as they theoretically can print an infinite amount of money. Just ask Zimbabwe how that's done. In fact, I keep a 50 billion Zimbabwe dollar note in my wallet to remind me of the possible hyper-inflationary consequences of quantitative easing. Whilst on the subject of Zimbabwe, I remember seeing a statement from their Minister of Finance who said they do not have sufficient goods in the shops to enable them to actually measure the full basket of goods required for them to calculate inflation.

No one knows what the actual inflation rate is and I have heard estimates of approximately 230 million per cent.

Returning to the subject of QE, in the last few weeks we have seen the Fed join the Bank of England in this new radical monetary experiment and I strongly feel that both Britain and America have decided that they are prepared to sacrifice their currencies in pursuit of saving their economies. This leads me to suggest that if I were Saudi, Chinese or Japanese I wouldn't buy another single US Dollar given they already own a few trillion of them. So what are they left with? The Swiss are selling their currency, the Americans and the British are running the printing presses, which suggests that the creditor nations will probably look at the currencies of those countries that are not pursuing QE which means the Australian Dollar, Canadian Dollar and the Euro. The Euro, however, has its own problems and some suggest that the risk of a break-up of the European Monetary Union is now growing. Such anxiety further strengthens the case for buying the commodity currencies of both Australia and Canada.

It would appear we have just fired the first shots of a competitive currency devaluation war. Some would argue that this is just another version of protectionism. In the meantime the Asians and Arabs will probably not be too keen to add to their mountains of US government debt and hence the announcement of QE by the Fed is an absolute necessity as they become buyer of first and last resort of US government securities as the creditor nations say enough is enough.

All of this suggests that we are in a new and dangerous phase of the current crisis.

It is in such an environment of tectonic currency realignments that perhaps an exposure to gold looks quite sensible.

In and amongst this new era of QE the battle between deflation and inflation takes on a whole new dimension. The textbooks tell us that a period of savage asset deflation and credit contraction is well, how else can one put it, deflationary. We also know, however that once we get traction between money supply and the real economy, as we have highlighted in previous Pain Reports, that prices and or economic activity rises.

See earlier Pain Reports for discussion on the quantity theory of money, $MV = PT$. We know that the velocity of money has collapsed which is what happens in a liquidity trap, hence it is critical that the velocity of money increases so as to ensure traction between MV and PT .

So the sequence of events is likely to be deflation, followed by inflation. Central banks are claiming that they can sterilise or withdraw excess money once the economy stabilises and hence prevent the possible emergence of hyperinflation. This delicate process of fine tuning will indeed be fascinating to watch over the years ahead. Those advocating buying gold as an insurance policy suggest that we are on the verge of either hyperinflation and/or systemic failure and/or a collapse in the US dollar; and in fact most "goldbugs" are saying all of the above.



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But what alternative do policy makers from Washington to Woy Woy have?

The global economic patient suffered a cardiac arrest in the fourth quarter and is in intensive care. Do they simply walk on by and allow the patient to die, risking unimaginable social unrest as unemployment rises to Great Depression type levels. Or do they apply the defibrillators, as they are, to stimulate and resuscitate the comatose patient?

The debt paradox is plain for all to see. It was excessive debt that got us into the crisis in the first place and now governments are going into debt to get us out of debt. But this is classic Keynesian economics and in an environment of private sector balance sheet contraction we need to see public sector balance sheet expansion.

Now I don't know how this will all end or when it will end. Is there likely to be a happy ending to this unprecedented global saga which started in the mosquito infested stagnant swimming pools of the foreclosure capital of America, Stockton California? What we do know is that equity markets fell more than 50% around the world. What we also know is that on any technical measure they became very oversold. We also know that consensus bottom up corporate earnings forecasts were hopelessly in

denial through much of 2008 and now, at long last better reflect reality. So yes, this equity rally looks like it has legs as it recovers from a very oversold condition.

But I would think very seriously about what's next. I therefore remain of the view that this is a cyclical rally in a very powerful secular bear market.

I think the US dollar is in serious trouble and would favour commodity based currencies. I also think that commodity prices look like they have formed some kind of bottom.

Ultimately I favour, as always, an investment approach which enables one to be flexible in an environment such as this. Set and forget, buy and hold, strategies are incredibly risky when the tectonic plates of the financial landscape are grinding together. Surely some kind of insurance is necessary at a time such as this?

I have been very impressed by the performance of equity markets since their March lows and as I said earlier, this rally looks set to impress and has some legs. It is always comforting being the contrarian that I am, to have seen the capitulation by bottom up equity analysts and various economists and their proclamations of doom in March 2009. Where were they in 2007 and 2008? As the saying goes

the trend is your friend and stay with it until proven otherwise. Fortunately the absolute return approach provides flexibility and enables us to adapt to the ever changing market. What continues to worry me, however, is the resolution of the deflation versus inflation debate and the "What happens next?".

Can the world's central banks fine tune and manage the "extraction and sterilisation" of liquidity once the economy gains traction? This is, indeed, the multi-trillion-dollar question of our time and guess what... I have absolutely no idea if they can or not and I am prepared to admit that I just cannot predict this outcome with any degree of confidence. But this is soon to become the question that markets will try and answer.

All the best,



Jonathan Pain

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