

# The Pain Report

From the desk of HFA Asset Management's Jonathan Pain

## The Big Banana

**'Buy and hold is now dead, as is its conceptual foundation, the efficient market hypothesis.'**

In the late seventies an economic adviser to Jimmy Carter, by the name of Alfred Kahn, purportedly said that there was the possibility of a deep, deep depression. Kahn was told in no uncertain terms that he was never to use this word and thereafter Kahn decided to say that America was in danger of having the worst banana in 45 years.

Over recent months we have all breathed a huge collective sigh of relief that the worst appears to be behind us and that financial Armageddon is fading like a very bad dream. Yes, the numbers are still horrible but "greenshoots" are being spotted everywhere and the V-shaped global recovery forecast is gaining serious traction amongst the "chattering classes".

The long-only money managers and legions of mainstream economists, none of whom spoke about the American housing bubble or the debt-gorged American consumer, are back in the saddle, whip in hand, yelling "Giddy up, we're off to the races".

Now before I launch into a tirade of cross examination, I wish to point out that I did, indeed, concede in the March and April Pain reports that I too felt an enormous sense of relief that, in fact, the world did not indeed end and that it is quite understandable that the markets should enjoy a huge reflexive sigh of relief and that the 1,000 level on the S&P 500 was possible. At the time of writing the high has been 956.23, achieved on 11th June. I have also tried valiantly to suggest that we should all adopt a more flexible and open-minded approach to the markets and that now is not the time to be either a "perma bear" or a "perma bull". Buy and hold is now dead, as is its conceptual foundation, the efficient market hypothesis. What the Great Crash of 2008 surely taught us, as did the Tech bubble, is that markets are not efficient as we are not at all times rational. The madness of crowds is surely

now beyond dispute and we need to build an investment industry which better reflects the reality of the world we live in and the frailty of human nature. The fundamental and undeniable flaw in the mainstream, relative-return approach to managing money, is that it is predicated upon the belief that buy and hold makes sense. This extraordinary nonsense leads, as we all now know, to a situation where at each and every price point on each and every day the observation is that it's a good time to buy.

Now back to the big banana.

A report written by Barry Eichengreen and Kevin O'Rourke, which can be found on the website [www.voxeu.org](http://www.voxeu.org), has got a lot of attention over the past few months as it compares the current crisis with that of the Great Depression and, according to their analysis, world trade has fallen more sharply in the first 15 months of this crisis as compared to the same point in time during the Depression. Global industrial production is meanwhile tracking very closely to the profile we saw at the beginning of the Depression.

The authors, however, are at great pains to point out that "this time" policy is, however, far more stimulatory than at the same stage of the Depression. Phew, thank goodness for that!

So are we in a depression and just too polite to say it in public and have we all got a dose of the Alfred Kahn "bananaitis"?

Now, there is no formal economic definition of a depression, but most would agree that it is an economic environment characterised by a significant and prolonged contraction in economic activity, accompanied by a prolonged period of rising unemployment and a decline in prices over a reasonable period of time.

Let's look at the deflationary condition first.

Ouch!!

At the time of writing the majority of the world, when measured on a GDP basis, is now in deflation.

The Big 3 of America, Japan and China lead the way and many others have recently joined the deflationary club such as Spain, Ireland, Belgium, Sweden, Singapore, Portugal, Finland, Switzerland etc.


If you add up all their GDPs you find that more than 50% of the world economy is now in deflation.

The problem with a depression is that it is only possible to say that we have experienced one once it has happened. So, maybe we are already in a depression and just too scared to say so; maybe we should just do an Alfred Kahn and say we are in a big banana and that will sound so much better. Or maybe we are in an Anglo Saxon depression with a developing world, led by India and China, that is just chugging along its long-term secular path to inevitable parity with the developed world sometime in the next few decades.

Maybe this is just the end of the first act of the Great Decoupling play, which is another word we were told we were not allowed to use, just six months ago.

Maybe this is the first part of the adjustment we just had to have as when something is simply unsustainable it usually isn't sustainable and the shop till you drop, gorging at the debt trough, American consumer just could not continue to spend more than they earned.

So now we see Chinese car sales going through the roof as American car sales crash through the floor, but we're still not



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allowed to use that word “decoupling”, and we also know that we are not allowed to use the word expensive when talking about Australian housing, we have to use the word “unaffordable”. Affordability crisis sounds so much better than a housing bubble. Notice how over the last decade banks and their economists use the word credit instead of debt. Credit sounds so much better doesn't it?

The fact of the matter is that we are witnessing an unprecedented process of deleveraging in much of the developed world. That's what happens when debt bubbles burst, get over it. The Fed flow of funds data shows that we have just seen two consecutive quarters of declines in U.S household debt for the first time since records began. In my view, we have many, many years of more of the same. So the big seismic, tectonic drivers are deflationary NOT inflationary.

Lets deal with deflation first before we start going on and on about inflation.

There is vast surplus industrial capacity all around the world and the Chinese are doing everything they can to build even more capacity. This is deflationary, I repeat deflationary not inflationary.

So at the risk of repeating what I said in my last Pain Report and in fact to be perfectly honest, what I have been saying for far too long, the developed world, in particular the Anglo Saxon world, needs to understand that the world has just changed.

Over the next several years we will see a process of normalisation as the profligate collide with the new reality of frugality. Governments will in the meantime spend every penny they can beg, borrow or steal to ease the pain, but this will too face a fiscal reality some time in 2010.

Companies around the world will re-build their depleted inventories, as mentioned before, which will give much traction to the view that it's all over and industrial production will look decidedly V-shaped over the next several months. The commensurate chatter amongst the mainstream money managers and economists of “told you it's all over” will drown out any mention of debt, deflation and other similar nasties.

The summer rally wobbled a bit through June and into July but I still feel the market wants to target the 1,000 level on the S&P 500. The economic data will continue to improve as companies re-build their inventories and Chinese data will continue to impress through the summer months. As we then head for the northern winter the word deflation will gain greater traction and investors will start to question the sustainability of fiscal stimulation and see the reality of consumer frugality and people will feel that they can talk openly of the “Big Banana”.

One final comment on the inflation versus deflation debate.

In recent months some highly-respected commentators such as Faber and Rogers have made headlines regarding the inevitable prospect of hyperinflation and Faber has gone further to compare America to Zimbabwe.

One of the popular expressions about the cause of inflation is that it is due to too much money chasing too few goods and in Zimbabwe's case this is certainly true as the central bank has been pumping trillions and trillions of dollars into an economy with very few goods. In fact, some years ago the Zimbabwe minister of finance made the point that they could no longer

calculate the rate of inflation as there were insufficient goods in the shops for them to calculate the price change of a “basket” of goods!

Now, we may indeed have the world's central banks flooding the global economy with money, but we at the same time have too many goods and huge amounts of excess industrial capacity, just ask the car companies around the world. Furthermore, one only has to study the Japanese situation to see how too much money can simply be saved and not spent, regardless of how low interest rates are and despite how much money the central bank creates. Yes it's called a liquidity trap.

So despite my profound respect for Faber and Rogers, I think the comparison with Zimbabwe is not a valid one. Yes, we have too much money, but we also have too many goods hence the great deflation that we are presently experiencing as consumers and companies reduce debt and hoard cash and the financial system turns Japanese as they reduce their balance sheet and the velocity of money collapses. This is all painfully ironic as it was the shameful lending practises of the banks that created the Great Debt bubble in the first place and now they will prolong the deflation as they reduce their lending and perpetuate the “Big Banana”.

All the best,



**Jonathan Pain**

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