



Update October 21st 2015

“All quiet on the Western Front”?

We might be tempted to say “All quiet on the Western Front” as markets appear to have perked up but this may be premature. Markets appear to still be in a “bad news is good news mode” which while possibly conducive to optimism as to equity indexes, does not constitute a reason to increase asset allocations.

Attempts to stop deflation like running from Mont St. Michel tide

*Hopes continue to doggedly focus on continued low interest rates at the short end, buttressed by “to the bitter end” bond buying at the “Far Side” of the bond cosmos. Bold as these measures might have been at inception, policy makers have had to run very hard to outpace the steady march of rapidly worsening deflation. **This is comparable to hapless shell seekers jogging at the Mont St. Michel in Normandy when the high tide rolls in.***

We do not agree on good deflation bad deflation distinction

We are once again reading articles on the difference between “good” and “bad” deflation, based on the distinction between supply side and demand driven deflation. The good “supply side” deflation argument hinges on price reductions as a reflection of human ingenuity – technical progress.

The catch here is that we had technological progress in the last 70 years reducing the cost of specific items. However - we did not have deflationary strains on spending and nor falling asset prices deemed stores of value. The invention of the transistor did not lead to an increase in the real value of government debt.

Euro Zone – to those who have shall be given low interest rates

We are seeing continued strength in the Euro Zone bond markets as inflationary pressures are deemed non-existent. This simply reinforces our contention that the problem is not lowering interest rates for the “happy few” but increasing domestic demand. Even assuming pass – through to consumers, we are dealing with countries where the banking system has historically been far more prudent with extending retail credit than the US.

The ECB is trying to run a script based on the US credit system in countries with nothing close to its munificence. Borrowing in the US is considered a right – in Europe it is a privilege.

Commodities moving south – what about the shift to services?

Changing route, we are once again seeing commodities moving south on weakness in Japan and lingering nervousness from the Chinese GDP data. While some may argue that commodities are irrelevant in economies which are migrating to services, we beg to differ:

The developed economies are well along in their long trek

Manufacturing has not disappeared – it has moved to the emerging world, where it represents a massive part of the present and prospective economy.

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We are no longer in a center – periphery model – the periphery has become a buyer and not simply a raw materials provider or transformer. This is not Italy in the early 1950's! Low interest rates can raise bond prices but leave commodities unscathed!

Not losing sleep over the Saudi Riyal!

We are seeing renewed reports as to the soon to be devaluation of the Saudi Riyal under the strain of low oil prices and a 20 per cent budget deficit. It is worth remembering that Saudi Arabia, despite a high cash burn rate still has 654 billion US Dollars in reserves – roughly 20 X the amount of FX reserves per capita as China.

A readjustment of the peg, to leverage local currency costs and US Dollar revenue, is not tantamount to a sovereign default.

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