



Quarterly Strategy Report

Q4 2009

We have recently completed our Q4, 2009 Quarterly Forum at Armored Wolf where the firm's Investment Professionals reviewed key issues in the global marketplace and identified broad strategic investment themes for the coming months.

I. OECD Policy Response

In response to what has already been one of the most pervasive, deep and synchronized global economic contractions, policy makers in the United States, Europe and elsewhere have implemented unprecedented counter-cyclical policies. Arguably, the U.S. policy response has been the quickest off the mark and the most aggressive. The Federal Reserve rapidly lowered the cost of overnight bank credit to virtually zero, has engineered a positively-sloped yield curve and, innovatively, is paying interest to banks on their deposits with the Fed; all intended to aid bank profitability and shore up money-center bank balance sheets.

In the current realm of monetary policy, however, it is the quantitative easing which has been the most innovative. By openly buying financial securities (e.g., mostly mortgages) from banks and the market place, the Federal Reserve has expanded its balance sheet from around \$800 billion to over \$2 trillion. Further, Chairman Bernanke is clearly poised to expand it dramatically further, despite rhetoric to the contrary, should it prove necessary. This novel approach to easy money has been mirrored by the Bank of England, the ECB, Swiss National Bank and other monetary authorities. Here in the United States, the explosive growth of high-powered money despite fairly tepid growth of domestic credit, not only raises questions on the efficacy of these policies to kick-start growth but also foments concerns over a timely and effective exit strategy.

The implementation of counter-cyclical fiscal policy in the United States has been equally dramatic. With the Federal government and watchdog agencies forecasting annual \$1 trillion dollar deficits for virtually a decade forward, such a strong Keynesian fiscal impulse has not been seen since WWII. One can question the efficacy and structure of the spending related to the "Recovery Act" given that it seems unduly "back-loaded". Only 33% of the allocated funds from this Law have been spent and/or committed, to date. Moreover, there remain additional questions on what portion will actually create jobs and stimulate the growth of domestic demand, rather than either "spilling away" through imports and stimulating foreign manufacturers, or alternatively simply representing unproductive pork-barrel spending which will build "bridges to nowhere".

What is clear is that such large deficits require a very aggressive ongoing US Treasury issuance program which has already begun in earnest. So far, there have been no real failed auctions, perhaps because there remains material residual doubt amongst a plurality of investors on whether the U.S. faces deflationary growth. Nevertheless, given the magnitude of future deficits and their apparent extended time line, the ability to successfully fund these auctions remains a risk. The Federal Reserve has already begun to house (i.e., monetize) some US Treasury debt, albeit in diminutive amounts so as not to spark a shift in inflationary expectations.

Concurrently, we have clearly seen actions by the Chinese which suggest they feel sated with US dollar denominated debt. They have stopped buying agency paper, are beginning to shorten the duration of their US Treasury holdings, have increased gold holdings in official reserves, and are using official funds to acquire foreign energy, natural resource and mining companies in Singapore, Australia and Canada. They are also using their deep financial pockets to extend their geopolitical influence in Africa, central Asia and other natural resource rich regions. The "Great Game", which started in central Asia in the late 19th century and pits sovereign states against each other over the control of energy and other natural resources, is alive and well. It requires vast spending on military hardware, standing armies, "imperial reach" and influence peddling to gain a relative advantage. As we increasingly compete on this turf with our largest sovereign creditor, who is already showing unease with their inflated US Treasury holdings, it remains an open question how long they can or will accommodate our voracious appetite for more issuance. Barring a renewed sense of fiscal propriety amongst U.S. politicians, we at Armored Wolf believe that there remain palpable risks of a steepening of the UST yield curve, ongoing US dollar weakness and possibly even a U.S. dollar crisis.

We do believe that the unprecedented counter-cyclical policies by U.S. and other OECD policymakers has put a floor under the economic contraction and precluded the risk of a debt deflationary spiral. Yet, despite dodging this bullet, serious lingering concerns remain on several levels. For decades, the main driver of the US economy, indeed that for the global economy, has been the U.S. consumer. Given that the U.S. household is reducing its spending, raising savings and de-leveraging its balance sheet, can the U.S. soon return to trend growth? Will our foreign creditors and the financial markets allow the profligate U.S. government to indefinitely compensate for weak private-sector demand? Will the huge interventionist government role structurally undermine a degree of U.S. entrepreneurship and impair the resilience of the economy's most valuable 20th century trademark? If the U.S. government is unable or unwilling to smoothly unwind its unprecedented extra-economic role, is

a strong inflationary impulse inevitable, and would this further erode the value of the U.S. dollar, sparking demands for an altered global exchange rate regime with a new reserve currency?

II. OECD Recovery

With all the talk in the press about U- and W-shaped recoveries in the United States, there seems to be little recognition that, to date, it has been V-shaped. After the positive annualized quarterly print of +1.5% in Q2, 2008, the economy fell off the cliff and contracted -6.4% in Q1, 2009. The rate of change in Q2, 2009 GDP, just released, has strongly rebounded to a decline of only -0.7% QoQ annualized. The Federal government's aggressive fiscal response and safety net under (most of) the money-center and investment banks, coupled with unprecedented assistance from the Federal Reserve have allowed GDP to quickly rebound. Additionally, with (dubious) FASB reforms on mark-to-market and other chimeras, the largest banks have stabilized, moved back from the brink of systemic risk and quickly returned to "profitability". Ample, if not excessive, liquidity has also spilled into risk assets and sparked rallies in global equities, high-yield debt, EM debt and equities and even mortgage-related products, rekindling animal spirits and re-enforcing bullish views. Yet, so far employment losses mount, the unemployment rate grinds higher and average home prices are off 30%, meaning that little relief has trickled down to the household. So are these nascent signs of stabilization and green shoots sustainable?

Recall that this recession is not in any way typical. Most U.S. recessions in the past 90 years were initiated by the Federal Reserve. Typically in response to an inflationary impulse which is becoming embedded into expectations, the Fed would engineer tight money and an inverted yield curve. The resulting high inflation-adjusted interest rates would then slow growth and quash inflation. When the Fed then lowered rates, the next recovery ensued. By contrast, the onset of this current recession occurred within an environment of easy money: a positively sloped yield curve, essentially a zero inflation-adjusted Fed Funds rate and flush liquidity.

So this recession was essentially caused by the crushing weight of excess leverage on the household's balance sheet, primarily, but not exclusively, driven by excessive mortgage debt and exacerbated by ill-conceived mortgage innovations. This aptly describes not just the current recession in the United States but also in the UK, Ireland, Spain, Hungary and New Zealand, amongst others. Such *Minsky*-style debt-deleveraging recessions create contractions which, on average, are longer and deeper than the *generic* recession initiated by monetary authorities.

Armored Wolf believes that the consumer de-leveraging will be a multi-year process. Overly indebted balance sheets, house price deflation, weak inflation-adjusted income growth, prospects for higher taxation, weak employment growth, and an aging population approaching retirement will all be significant head winds for the return of consumer ebullience. It is quite likely that the unusual move during the past decade when consumption/GDP rose from 67% to 71% during the credit binge will be mostly unwound. Hence, as the private sector, particularly households, increase their savings, the government will be forced to dis-save to sustain some modicum of growth. Consumer dis-saving will also imply below-trend consumption growth. In turn, excess capacity in retail, financial and other services will mean that employment growth should remain anemic.

Despite this torpor, we would not be surprised to see GDP growth in Q3 and Q4, 2009 surprise to the upside as spending from the Recovery Act gains traction and as investors are cheered by the "recovery" in bank earnings. However, we believe these results will be transitory. Even with another round of government-sponsored (fiscal and monetary) stimulus, we expect the debt-deleveraging process to remain the dominant secular trend. Hence, below-trend growth with the destruction of supply side capacity in housing, commercial real estate, retail, banking and other ancillary services is likely. Even with a second round of stimulus, which we expect, the spending of the hapless U.S. consumer should remain muted, suffering downsized expectations and a declining standard of living. Once again, such a muted recovery in private-sector demand will likely elicit an aggressive and sustained government intervention. Yet, are their limits to this role?

During the "Lost Decade" in Japan, pro-active fiscal policy saw government debt-to-GDP rise from below 100% to around 270%, despite having a *de minimus* effect on growth and employment. With U.S. Federal government debt currently below 100%, there should be plenty of room to leverage the Federal government balance sheet to fund counter-cyclical Keynesian spending, assuming Congress has the political appetite for chronic deficit spending. Yet when Japan accumulated this domestic debt, they benefitted from a strong currency and a current account surplus. The United States does not have these luxuries. Although we expect the activist US government to manufacture short-term growth, we expect this to be achieved with diminishing returns. Thus, our base-case growth outlook is for a sustained, below-trend recovery. Deferred problems, such as heavy indebtedness, excess capacity in real estate, surplus US dollar liquidity and weak bank balance sheets, are likely to resurface. When they do, risk markets may not react as positively to Federal interventionism next time around. If the government faces some combination of failed Treasury auctions, a steepening UST yield curve, a weakening US dollar, or even a tax payer revolt, then the below-trend, but sustained, recovery that we anticipate could devolve into a double-dip or even serial recessions.

Armored Wolf also believes that above-trend inflation over the coming years is highly likely as the Federal Reserve will be forced to hold more and more debt issuance from the US Treasury. Notwithstanding his innovation of quantitative easing, Chairman Bernanke's analytic framework is broadly consistent with the Federal Reserve's behavior since its creation. It seeks to avoid downside surprises at all costs and essentially mandates the Fed to offset any deleveraging or deflation with aggressive QE and other nonconventional tools. Thus, the US dollar, despite benefiting from brief rallies as risk markets correct, should continue to lose value on a secular trend. After all, the Federal Reserve in engineering minimal debt deflation episodes since their inception in 1913, have contributed to the US dollar losing over 90% of its purchasing power since that time. There is no end in sight for this strong secular trend whilst the largely unaccountable and opaque private-sector Fed remains ensconced in their cozy arrangement.

III. Global Locomotives

The only real global locomotive in the Bretton Woods era has been the United States economy and the U.S. consumer, in particular. As we have outlined in the above sections, we believe that the ability of the U.S. consumer to play this role will be severely diminished for the next several years, at least. This, of course, begs the question: is there an alternative?

China has implemented its own massive fiscal stimulus this year which not only has kept it from recession but has allowed growth to rebound and be driven primarily by domestic demand rather than export-led growth. In principle, this should allow it to act as a global locomotive, yet we believe this remains unlikely. Whilst we do believe that China's current account surplus will narrow, as imports grow more rapidly than exports, the smaller size of its economy relative to the U.S. and the modest percentage of domestic demand attributed to consumer spending suggest that it cannot replace the US as a global locomotive. That said, Chinese demand over the past decade has already had a material impact on global commodity prices in certain industries and we expect this to continue. So for countries that are growth reliant on commodity exports where China represents a significant share of tradable demand (e.g., copper, zinc, iron ore, etc.), they will materially benefit. Additionally, there has been increasing *de facto* integration within Asia over the past decade as represented by growing intra-Asian trade. China has now replaced the United States as the dominant export market for a number of smaller Asian countries. Here, analogous to the industry or sector trade linkages, China will play an increasing role as the locomotive.

Looking at Japan and the Euro-zone, we also do not see them being able to fill the void of the US economy as locomotive. Japan's price and income elasticities of import demand are simply too low to send positive transmissions and linkages abroad to drive global growth, despite the requisite size of its economy. Moreover, we view these elasticities as culturally-determined and unlikely to change even with the recent historic election result and regime change in Tokyo. Europe's growth is primarily driven by intra Euro-zone trade and domestic demand in each respective country. If we are right that the US dollar will continue its secular decline, then a stronger real effective exchange rate in Europe, Japan and elsewhere will also impart a further deflationary impulse on these regions.

Since there is no single country or region that can act as a locomotive for global growth, we expect the world's economic activity to underperform its trend rate. This, of course, does not mean that individual countries or even regions cannot regain or even exceed past growth rates. Already, as mentioned, we are seeing policy shifts in China which are changing the drivers of economic activity from export-led to domestic demand led growth. More broadly, we favor risk markets in countries such as Brazil, India, Russia, Indonesia and others where growth is primarily driven by domestic demand, owing to our view of below-trend OECD growth, competitive currency depreciations and perhaps even a rise in trade protectionism.

IV. Oil and Energy

After peaking at nearly \$150 per barrel, dropping to \$33 and rebounding to current levels of around \$70, crude oil has exhibited as much volatility as just about any commodity or financial asset. Whilst we believe that the price move to \$100 per barrel was necessary to equilibrate supply and demand, the last \$50 or so was driven by excess liquidity and the speculation of momentum traders and other arbitrageurs. Whilst demand has clearly been reduced by the recent synchronized global recession, \$33 per barrel was also an overshoot to the down side. We at Armored Wolf believe, given the current state of the global economy, that the "fair value" price for crude oil is currently in the range of \$60-80. This calculation is driven by our view of the estimated marginal production cost per barrel combined with the consensus target amongst OPEC members and our view that demand recovery will rebound and accelerate in the near term.

The U.S. currently consumes about 24% of the world's total demand of 85 million barrels per day. Interestingly, U.S. demand is down only 2.0mbd from its peak demand prior to the recession, suggesting income inelastic demand. Nevertheless, virtually all incremental demand for crude oil in the past decade has come from growth in emerging markets while demand has been stagnant in the OECD during recent non-recession years. This trend, together with a decline in non-OPEC production in the last couple of years, has been a key factor in pre-recession price trends. Given this growing fundamental nexus between emerging

market growth and demand for commodities, cross fertilization of specialist insights is one of the reasons Armored Wolf captures trading synergies which enhance our performance.

We put little credence in the concept of peak oil, except in one sense. We believe there is still plenty of oil in the ground and under the sea, whether in the form of light and heavy crude, tar sands, or oil shale, so that the fossil fuel-based economy that the developed world has known for the past century is not materially at risk. However, with many big, low-cost producing crude oil fields in decline, new replacement production will necessarily increase the cost of extraction. Hence, the exploration and production segment of the industry is expected to suffer from margin pressures which undoubtedly will be passed onto to the end consumer once the economy normalizes. We believe that, ultimately, demand for crude oil will lead to an adequate supply response, at a price; a sort of reverse *Say's Law* which postulates that supply creates its own demand.

Beyond the longer-term cost-push secular trend in crude oil prices which we foresee, there are several other drivers for crude oil prices which we continue to monitor very closely. As we have outlined, the world is becoming increasingly awash in US dollar debt, which may be facing increasing investor disinterest given their sated portfolios. With seemingly never ending prospects for further US dollar issuance, the Greenback seems to take on more and more characteristics of a fiat currency. Investors are becoming more acutely aware of this issue and have periodically sought refuge in hard assets, namely energy, industrial and precious metals. Without another *Plaza Accord* to change the US dollar's trend or a new Bretton Woods style agreement to create a multilateral reserve currency alternative to the US dollar, we believe this inversely-correlated, monetary effect on US dollar denominated commodity prices from a weakening dollar will not only persist but perhaps even increase in intensity, thus pushing prices even higher in US dollar terms.

The other key driver for crude oil is geopolitical-based supply disruption. While it is relevant only infrequently, it has material impact when it is. For example, rebel activity in Nigeria has recently led to upward pressure on global oil prices. This is an ongoing problem in the Niger delta which shows no sign of quick resolution and undoubtedly will continue to be periodically disruptive. Perhaps even more ominously, tensions in the Gulf between Iran and the IAEA remain escalated, despite Iran agreeing to inspections at its second enrichment facility in Qom. We know that a military option "remains on the table" both for the United States and possibly Israel, and understand how damaging that could be to energy and financial markets.

As for the state of the current crude oil market, we see a surfeit of energy, both crude oil, natural gas and distillates, not just in inventories but also spare production capacity. This is entirely borne out by North American rig counts, daily rental rates on oil drilling equipment, tanker rates and their availability. Therefore, barring unforeseen supply disruptions, we see the crude oil price capped near current levels and would be short the front end of the futures curve and long the back end, benefitting from contango. Longer term, we believe that the U.S. monetary and fiscal excesses will result in significantly higher inflation, including energy and commodity prices.

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