

### **Armored Wolf's Q3 2010 Quarterly Forum: A Recap**

During our recent Third Quarter 2010 Forum, the first discussion focused on Europe – prospects for sovereign defaults, bank solvency and policy rifts determining the future of the Euro and the Eurozone.

With Greece having secured a successful roll-over of its heavy amortization schedule earlier in the year, coupled with the successful beginning of its multi-year fiscal consolidation program, events in Athens fell from the headlines and somewhat eased investors' concerns. The announcement of the European Financial Stability Facility (EFSF) also had a stabilizing affect on investor fears and risk markets, particularly given that not just Greece, but Spain, Portugal, Ireland, even Italy or the UK ultimately could be vulnerable to a sovereign debt restructuring under certain scenarios.

After Greece's near-term stabilization, market concerns briefly turned to Spain and Portugal, however, successful refinancing and the placement of new debt eased market concerns for now. We believe the risk of sovereign restructurings in Europe will create a rolling, multi-year uncertainty. It inevitably will arise again to roil risk markets, perhaps in tandem with the bunching of the most vulnerable countries' amortization schedules.

A timely reminder from Carmen Reinhart and Kenneth Rogoff in their recently published book, [This Time is Different: Eight Centuries of Financial Folly](#) suggests that when sovereign indebtedness becomes excessive, in this case greater than 90% of GDP, the macro economy under performs in many ways. We understand that these highly leveraged economies will face a multi-year timetable of fiscal consolidation, ensuring below-trend growth of income and output. One of life's hard truths is that if you live beyond your means, the day of reckoning ultimately arrives—either in the form of default, a debt restructuring and/or austerity to generate savings to repay the years of excess.

The policy decision for a pan-European bailout of Greece was not easily reached. The EFSF along with the ECB beginning its program to purchase EU sovereign debt for its balance sheet was essentially a French proposal. Yet Germany's Calvinist bent meant that President Angela Merkel originally was not on board with this approach. Ultimately, the bailout proposal was adopted at some significant political fallout for President Merkels' coalition. This in turn gave her added clout to insist it was time for all Eurozone countries to tighten their belts to meet the Maastricht criterion of fiscal deficits below 3% of GDP. Once again, French President Nicolas Sarkozy and Germany's President Merkel were at odds, with the French proposing a more reflationary policy response. In the end, the ECB Governor Jean-Claude Trichet weighed in for the austerity program and that ruled the day.

Although the markets were pleasantly surprised with signs of stronger growth from the UK with their Q2 GDP print and with Germany's strong Ifo Institute numbers for July showing business confidence at a 3-year high, we believe the goal of fiscal tightening will imply sub-par growth in Europe over the next several years. It also implies that monetary policy rates set by the ECB will remain lower for longer. While there are important differences between the monetary authorities in Europe and the Federal Reserve, we believe the magnitude

of the Eurozone sovereign debt “crisis” will severely contain the reflationary options of the ECB for some time.

The European banks are another important linkage. The pervasive cross-holdings of EU sovereign debt, with German and French banks holding the largest concentrations of sovereign debt from Greece, Spain, etc. obviously paints the financial support for Greece as implicit support for the Eurozone banking system. It is not implausible that a Greek default, were it to occur, would morph very quickly into a banking crisis in a number of EU countries. In turn, this would require each sovereign to act as lender of last resort for their respective banking system and in the case of the PIIGS, possibly trigger a sovereign default as well since the cost of the bank-sector bailout would be too much leverage for the sovereign to bear. Such a rolling crisis of contagion is to be avoided at all costs, suggesting that were Governor Trichet required to allow more inflation or to grow the ECB balance sheet with more sovereign debt he would do so, despite his exhortation to the opposite.

It also is in this spirit that we viewed the recent bank stress tests as a lost opportunity for transparency and verisimilitude. Only 7 of the 91 European banks failed the test, requiring only a few to shore up Tier I capital. Yet the methodology of the exam virtually assured a good result all around. The prospect of any EU sovereign restructuring their debt and thus impairing bank balance sheets was assumed away. Further, the stress-test scenarios in the extreme were not overly conservative, so if EU growth falters it is certain some banks which achieved a passing grade would suffer.

What we believe has not received enough attention is the demanding refinancing schedule for the Eurozone banks: nearly EUR1.8 trillion over the next three years. Such a heavy amortization schedule raises many questions: will the banks compete with sovereigns for investment capital; will the non-bank private sector get crowded out of financial markets; and will the banks receive adequate term financing to smooth out this schedule or with access primarily limited to shorter-term funding, will this roll-over vulnerability simply be extended into the future? Lastly, if a significant number of EU banks are unable to successfully refinance their debts, would the sovereigns or a pan-EU lender-of-last resort have adequate capability to take on these debts, thereby leveraging their own balance sheets even further? The relevance of such questions will be with the markets for some time.

At Armored Wolf, we understand that addressing systemic banking problems requires several years, perhaps even a decade, to resolve. We are not unsupportive of the current policy mix within Europe, nor do we doubt their commitment to resolve this problem with minimal market turmoil. Yet we believe that weak credit growth as banks’ repair their balance sheets, coupled with the required fiscal consolidation for many EU countries, not just those that are highly levered, will result in sub-trend growth and mild deflationary pressures for the foreseeable future.

Europe’s choice on the policy mix is driven by their socio-historical European experience that is much different from that of the United States (e.g., German hyperinflation). Unlike the US, the EU will try to avoid an aggressive reflationary monetary and fiscal response to their crisis. Rather, they will attempt to pursue austerity, stabilization and ultimately attempt to grow out of the problem. Hence, the likelihood of a full-blown reflationary policy response to the problem of EU sovereign indebtedness whereby the ECB launches a second, and even larger, QEII, will only be pursued in response to a dramatic worsening of the crisis.

So a slower growing Europe, with a weaker (i.e., competitive) currency will clearly be deflationary for the world economy. Compared to the pre-crisis growth rates of around 2.8%, the industrialized countries will

likely advance at no more than about two-thirds of that pace. This underlines one of our investment themes at Armored Wolf: overweight emerging market countries; companies and currencies whose growth is driven by domestic demand in their own country. The old global model, where industrial countries and most particularly their consumers act as the world's growth locomotive, is impaired and perhaps even forever changed. Those countries that can ignite growth from internal demand—consumption, investment and government spending—will enjoy rapid growth and strong corporate profitability irrespective of sub-par global growth.

Our second discussion topic focused on the United States – enquiring whether its recovery from recession was stable, based on the internal components driving growth. This question obviously is intimately intertwined with the sustainability of funding the Federal fiscal deficit and there being sufficient demand for more US dollar assets in the portfolios of our foreign creditors.

While not yet officially validated by the National Bureau of Economic Research (those charged with doing so), the US recovery seems to have begun about one year ago. Quarterly GDP numbers, post-revision, reveal a fairly strong initial rebound in growth during H2 2009, despite what now seems to be a deceleration during H1 2010. Most recently, Q2 2010 GDP registered an underwhelming +2.4% growth rate, significantly less than the robust +5% as recently as Q4 2009. Preliminary component data for Q3 suggests that GDP growth will continue to decelerate in this quarter.

Essentially, we believe the V-shaped recovery that investors hope for and have largely priced into the US equity market is now losing steam, with the policy stimulus from both fiscal and monetary policy fading and the structural headwinds to growth remaining stubbornly immovable.

Unlike Europe, the United States continues to pursue profligate fiscal policy; the \$1.47 trillion Federal deficit this year is expected to remain about the same next year between 9% to 10% of GDP. With slumping tax receipts due to the still weak economy, this requires the US Treasury to borrow about 41 cents of every US\$1 it spends.

Congress seems unlikely to grapple with the issue until after mid-term elections. With new taxes embedded in the recent ObamaCare law and the Bush tax cuts set to expire, current fiscal policy, despite the untoward size of the deficit, is set to generate a negative fiscal impulse next year, barring a pro-active adjustment by Congress. It remains somewhat uncertain whether the new landscape in Congress after the mid-term elections will have the appetite for another major fiscal stimulus package. However, even if fiscal policy tightens somewhat as a result of inaction, there seems little appetite by US policymakers to embark upon a fiscal consolidation policy similar to the Europeans.

Monetary policy in the US remains easy as profiled by the Fed's near-zero interest rate policy, its current \$2.3trillion balance sheet (having grown about three-fold) and its widely anticipated intention to pursue QEII should risk-asset markets meltdown or should there be further evidence of a deceleration in growth. So the policy mix in the US is quite different from that of Europe. There seems surprisingly little concern in the US about running fiscal deficits at around 10% of GDP and certainly no political appetite to target the fiscal consolidation goals akin to those like Europe's 3%.

While monetary policy currently looks similar on both sides of the Atlantic, the future intentions of the Fed and ECB seem more dissimilar. The power of the "doves" in the Fed is growing, particularly with Janet Yellen's likely imminent appointment as Vice Chair of the Board of Governors. This suggests that it is a

question of when, not if, for QEII. Moreover, one has an uneasy sense that the magnitude of another round of quantitative easing may ultimately dwarf the historic first round of QE, assuming markets allow it. Any attempt at QE-lite is likely to be thwarted by the markets.

There are plenty of structural impediments to re-attaining trend GDP growth in the US: tight credit markets, consumer de-leveraging, weak state and local fiscal health, rising home foreclosures, stubbornly high unemployment and a weak recovery in job creation and personal income. Perhaps the one we find most disturbing is the continuing collapse of credit.

The fractional reserve banking system is not currently functioning as it should. Certainly, the 25bps paid by the Fed to the banks for their \$1trillion of excess reserves on deposit is an impediment to credit growth. In addition, we believe there is an active credit crunch and perhaps even a liquidity trap both at work, as banks slowly work off the bad assets on their balance sheet and as consumers continue to de-lever.

Since all these structural impediments will take some time to resolve and will impede the economy's trajectory back to trend growth, this anchors our belief in the likelihood of another stimulus package and the certainty of another round of quantitative easing by the Federal Reserve.

The biggest uncertainty for the US economy is not the intended policy mix going forward, which will undoubtedly be loose, if not profligate fiscal policy and another burst of monetary ease. The latter will be accomplished by maintaining low policy rates, a removal of the rate paid on deposits of excess reserves and perhaps most importantly the purchase of more securities in the open market, once again ballooning the Fed's balance sheet. These we believe are virtually certain; it is simply a question of timing and perhaps the trigger. What remains less certain is how the risk markets and foreign investors will react to these policies.

With break-even yields below 2% and rising home foreclosures set to beat those from 2009, there is clear evidence of deflationary forces. As mentioned, credit growth remains negative; to us this is *the* definition of deflation. Weak price levels are really only a symptom. Yet the current monetary policy team headed by Dr. Bernanke views deflation as the ultimate scourge, thus confirming our view that QEII is a certainty.

Unlike the Japanese experience of the past two decades that has more differences than similarities to the current US situation, we believe ultimately the Fed will be successful in igniting the velocity of money and creating inflation. It seems clear that the banks are reticent to aggressively recognize all the dead weight losses embodied in a significant share of mortgages and other debts on their balance sheets and policymakers in Washington unfortunately seems loathe to force them. It also seems unlikely that we simply grow our way out of this leveraged mess. Therefore, inflation is the only way out from these huge debt levels.

So we see the road to inflation via the alley of deflation. We believe the trigger for QEII is likely to be further evidence of slowing growth, no rebound in credit expansion and further house price deflation. Whether this "slow" trigger is the catalyst or if the risk markets, discounting this scenario, become the "fast" trigger remains to be seen.

We see little value in US Treasury notes with yields at current levels. This is not to say they cannot go lower in the short-term, however, there is no long-term value here. We see a more nuanced picture with US equities. Those companies, mostly blue chips and multinationals, which still have access to bank credit and the capital

markets for finance and can target the bright spots in global growth (largely Asia and emerging markets), have been able to not only improve margins but also grow the top line. Other companies have found it more difficult either due to being credit constrained or facing weak final demand in their markets. Thus, whilst corporate profitability has “recovered” we view a growing disconnect between Wall Streets analysts’ rosy forecasts of forward operating earnings and a dichotomous economy that is again slowing.

We prefer to look at other parameters such as cyclically adjusted earnings (for example Shiller’s 10-year average of net earnings) or average dividend yields to value the US equity market. Using these measures, US equities are considerably overvalued. While that makes us cautious, we also acknowledge the wall of liquidity in the system, which is not being used to extend credit as per normal, however seeks risk assets in its increasingly desperate search for yield. So at the moment we remain neutral with a bearish tilt on the outlook for US equities with a keen awareness that the fully priced market could well suffer once further deflationary forces become evident. We expect US equities to continue to set the tone for global equities, particularly those in emerging markets. While we observe strong fundamentals throughout most of EM, “real sector” decoupling, for the most part, does not translate into financial-asset market decoupling.

Our biggest concern about the imminent QEII is its impact on the US dollar and to a lesser extent US Treasury yields. The Fed’s attempt to keep deflation at bay and smooth out the business cycle has been their goal since the institution was established in 1913. Largely as a direct result, the US dollar has been secularly weak and cumulatively lost around 90% of its purchasing power since then. We believe QEII will further erode the US dollar’s value. The response of US Treasury yields to QEII is less certain. Whilst one would believe the yield curve should steepen, there will be countervailing forces. The Fed may well target US treasury yields during QEII, trying to affect term interest rates and keep yields modest. It is also quite plausible that QEII will involve larger, perhaps even much larger, amounts of monetization of the fiscal deficit, ultimately with the same objective. Should this unnerve investors, particularly those with either large holdings or significant purchases of new issuance, the Fed may find it difficult to “cap” rates. We would be in trouble if the markets lost confidence in the Fed.

Our view of a weaker secular US dollar is the reason that we believe most commodities, particularly precious metals, crude oil, other energy, foodstuffs and certain base metals will be a very good store of value once QEII is launched. The weak US dollar outlook also attracts us to many EM currencies particularly those of resource-exporting countries like Brazil, Indonesia and Chile, for example. Also any EM companies that mine or produce the above-mentioned commodities are attractive.

While we believe the US economy will eventually return to trend growth, the current policy mix is not optimal and probably relegates the adjustment program to the slow lane.

The final Quarterly Forum discussion focused on the global rush to fiscal prudence, asking whether this is a replay of Hoover in the 1930s or Japan in the 1990s that threatens a renewed synchronized global recession or instead, whether it is an appropriate response in light of high debt levels and the growing popular backlash to profligate governments.

Global growth in 2010 should register around 3.5% still significantly below pre-crisis levels of 4.25% to 4.5%. Most of non-Japan Asia and virtually all emerging market countries are growing strongly with some even facing incipient inflation. In contrast, most of Europe, including Eastern Europe, the United States and Japan remain mired in sub-par recoveries.

Drivers of the global recovery in no particular order have been US fiscal stimulus, a G-3 (plus U.K.) monetary stimulus of historic proportion, China's growth and EM growth. Current impediments to growth have been weak OECD employment growth, impaired bank balance sheets in most industrialized economies, US household de-leveraging and more recently the EU sovereign debt problems and the region's fiscal policy response. With China beginning to slow a bit and some doubts on a second fiscal stimulus package in the United States, there is a question whether the drivers of growth can maintain the global recovery.

The contrast in the respective philosophies of Trichet and Bernanke, which underpins their policy stances, is beginning to show. Perhaps it is because of the starkly different mandates of the two central banks, with the ECB exclusively focused on price stability while the Fed has a dual mandate, including full employment. Should Europe slip back into a systemic banking crisis triggered by its large funding needs and resulting in frozen inter-bank credit as happened in the US during the Lehmann crisis, it is likely that Trichet would pull out all the stops. Short of a banking or sovereign debt crisis, however, we believe that the ECB will be less, not more, supportive of growth. The same is true of fiscal policy in Europe.

The view at Armored Wolf is that a deflationary debt cycle can be healthy for an economy by eradicating remnants of bad investment decisions during easier times. Trying to maintain levels on asset prices with heavy government intervention, that cannot be supported by fundamentals, is ill-advised. Further, privatizing gains in banks and other corporates whilst allowing them to seek taxpayer support for their losses is hugely inefficient for the economy due to moral hazard. Witness the unwillingness of US banks to extend credit despite their \$1trillion of excess reserves. The bailout of Greece may well be another example of bad policymaking, but only time will tell. However, we believe the fiscal tightening in Europe is more apropos than is the stance of fiscal policy in the United States. Whilst the former holds risks of falling back into another recession, the latter threatens stagflation and a currency crisis. We believe there should be more Schumpeterian "creative destruction" to pave the way for a solid, trend recovery.

With sustainable global growth and price stability as the goal, it is clear that the world needs to adjust current imbalances. As the US consumer is no longer the global buyer of last resort, the drivers of global growth need to be diversified. More flexible exchange rates, either nominal or real, in Asia and China in particular, would be a preferred policy adjustment furthering this goal.

Also, countries with current account surpluses, particularly those of Japan, Germany and China, would benefit from stimulating domestic demand. US Treasury Secretary Timothy Geithner has made the same point. However, it could be argued that there are structural impediments to de-emphasizing these countries' export-oriented growth. Perhaps a deeply imbedded mercantilist mentality is rife which of course seeks alliances with the political elite. Such structures will not be solved merely by stimulating domestic demand. Yet there are many countries currently classified as pursuing export-led development that are being driven this year by domestic demand (e.g., Republic of Korea, Taiwan, even China). We believe the ultimate decoupling of emerging markets' financial-asset performance will require the emerging market bloc, perhaps along with others (e.g., Organization of Petroleum Exporting Countries), to be able to *sustain* their growth independently from that of the industrialized bloc. China is now the second largest economy recently surpassing Japan. It may not be too many more years before we see the prospect of full decoupling.

The last key goal for global growth, particularly for sustained recovery in the US, Japan and Europe, is to lower debt levels. This is where the attempt to keep asset markets afloat with bank policies, and regulators' concurrence, to "pretend and extend" is unhelpful. Asset markets should be allowed to reach market-clearing

levels. Impaired debt due to insolvency not illiquidity, should be recognized as such, reserved against and written off. Doing anything less merely creates zombie banks that either cannot or will not lend. Without credit growth, economies cannot grow anywhere near their potential.

We expect a soft landing in China. Growth recently decelerated from 11.9% to 10.3% in Q2 2010. We see growth stabilizing in high single digits, driven by a balanced mix of foreign and domestic demand. The high-end residential and certain pockets of commercial property markets remain a risk, however, there is huge pent-up demand for lower income housing that can drive this industry in a stable way for years. The recent regulatory request for banks to stress test their real estate portfolios is another prudent policy move.

Trade linkages between China and Asia continue to grow apace. China has achieved regional locomotive status, however, not global. It also is selectively a huge marginal component of demand for other resource countries outside Asia (e.g., Australia, Brazil, Chile, Venezuela, etc.)

Summing up these divergent trends in key countries across the globe, we believe global growth will remain in excess of 3% for this and next year. This is admittedly below the trend of 4.5% but still not bad. If we are wrong, we believe growth will slow further, pulled down by some combination of a European banking crisis or a slumping US economy. As far as broad market implications are concerned, we believe that returns in equities, spread product and sovereign bonds will face lower average returns compared to recent trends. We also believe these lower expected returns will be accompanied by higher average volatility as asset markets are buffeted by the transitions occurring in the great global rebalancing and due to the structural shift of economic power from the occident to the orient.

Over time, we believe strong fundamentals in the emerging markets will underpin a secular tightening of credit spreads as economies benefit from further credit upgrades. It also will promote solid growth and corporate profitability, in turn under-pining superior equity performance in emerging markets. Thus any volatility in global risk assets initiated by policy missteps or bank crises or sovereign mishaps in the industrialized world, will be viewed as a good buying opportunity for emerging market assets. While our view is by no means apocalyptic, we believe that layering in cheap hedges for tail-risk events is prudent.

Happy Hunting.

Ronald Solberg, Managing Director  
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