8/1 Investment Round table from Business Times Singapore - "Making sense of the bear market"

Making sense of the bear market

PARTICIPANTS

Moderator:

Anthony Rowley, Tokyo correspondent for The Business Times.

Panellists:

Marc Faber, an investment adviser and publisher of the Gloom, Boom and Doom Report.

J Mark Mobius, president of Templeton Emerging Markets Fund Inc, and director and executive vice-president of Templeton Worldwide Inc.

Ethan Harris, managing director and chief US economist at Lehman Brothers, New York.

Ernest Kepper: A former official of the International Finance Corporation and Wall Street investment banker who now heads an Asian financial consultancy.

William Thomson, Chairman of Private Capital Limited, Hong Kong and adviser to Axiom Alternative Funds, London

OVERVIEW Since the sub-prime mortgage crisis burst upon the US a year ago, there have been market rallies and claims that the worst is over, only to be followed by fresh plunges in values and sentiment. Are we near the bottom now, or just at the start of a long, slow meltdown? Our experts take the latter view.

Where can investors find a safe haven in this sea of trouble and uncertainty? Gold is still a good refuge, suggests one expert, who expects the price go as high as $2,500 an ounce.

More fundamentally, our experts see developing markets in Asia and beyond as the promised land that will emerge relatively strong from a potentially massive destruction of wealth in the old world. The needs of these emerging markets for food and natural resources will be strong, so farmland and plantations could be good investments.

Anthony: I'm delighted to welcome such a strong panel - a mark of how seriously you gentlemen view the current global financial and economic situation. It's especially pleasing to welcome back some old friends - Marc Faber, Mark Mobius, Ethan Harris

and William Thomson.

Anthony: Marc, let's start with you. Are we looking at a financial system "avalanche" rather than a technical bear market, in equities and bonds?

Marc: I believe that the secular bull market in equities and bonds, which lasted from 1981/82 to anywhere between 2000 and 2007 has come to an end and that a water torture bear market has begun. If an enormous quantity of money is printed by central banks equities may avoid a severe bear market of say 40% to 50% but a trading range would still follow and no net gains - certainly not in real terms - would be achieved.

Mark: This may become the case in the US where there is a big risk ofa "meltdown" of the financial system, bought on by a lack of confidence. However, emerging markets, equities have corrected more due to poor market sentiment and contagion from what is happening in the US, rather than any major deterioration in fundamentals.

Ernest: I say this is an 'avalanche.' I am anticipating a fall in equity prices in the range of 40 to 50% relative to the peak— much more severe than the 25% fall which we see in a recession.. Two main reasons are that major economies other than the US will have severe interruptions in growth and that the consumer - especially US. consumers who most likely have gone further into debt than their credit cards would allow by making a home equity loan or taking on the second mortgage will most likely be under pressure to repay. It appears that the U.S. consumer's debt burdened situation will put him in a "no way out" financial quandary with a fall in home prices, fall in equity prices, rising inflation and a reduction in jobs. I expect this scenario to unfold over the next 12 to 18 months.

Bill: In no way can this be seen as a normal bear market. This is undoubtedly the worst financial crisis in the developed world since the 1930s. The only period remotely similar was the bear market of 1973-75, which was itself a part of the extended 1966-82 bear market in US shares. That bear market was driven in part by a 13 fold increase in oil prices from 1972 to 1980. This time we have had a 14 fold increase in oil prices from the $10 low of 1999. Last time we had massive inflation of 20 percent per annum. That has not yet arrived but may well be in the pipeline.

However, in my view, the situation is far worse this time since the US financial system is extraordinarily stretched and stressed. Last time we only had the minor bankruptcies of Franklin National Bank and Continental Bank to contend with. Then there were no derivatives. This time, they amount to more than 10 times world GDP and a greater multiple of bank capital. Within that total the most toxic ones are those unlisted, opaque, over the counter variety amounting to over $50 trillion, again multiples of US bank capital.

The revolution in market finance that began with the deregulation of the 1980s may be about to eat its young, as we have seen with the putative bailouts of Fannie Mae

and Freddie Mac; if nationalization goes ahead the US visible national debt increases by $5 trillion and is effectively double. The US would no longer qualify to join the Euro!

The US budget deficit could be on the verge of exploding upwards. Including war costs, it is already over 4 percent of GDP. The economic slowdown and Presidential candidate Obama's plans for healthcare, whist noble and justifiable, even after tax increases, could send the deficit north of $1 trillion or 7 percent of GDP by 2010.

Anthony: What do you think the total "wealth loss" might be as a result of recent crises (in terms of falls in market cap, sub-prime losses and other losses by banks and investment banks, derivatives market losses in general)? Does anyone really know - or is the whole thing too opaque to estimate?

Ethan: Estimating the losses of financial institutions is extremely difficult, but something in the $500 bn to $1 trillion range makes sense. The good news is that much of that has already been revealed at the major money centre institutions and they have been able to recapitalize. It is also important to not double count–when a mortgage defaults the loss is the difference between the loan size and what is recovered, and we should not add to that the individual pieces at each stage of ownership of the loan. To put the losses in perspective, the total value of assets owned by US households is $72 bn and the net worth of US households is $56 billion. Moreover, many of the losses are borne outside the US. Thus the second round losses–the drop in the stock and housing market–is larger and a bigger threat to global growth.

Bill: When Chou En-Lai was asked by Henry Kissinger if he thought the French Revolution had been a success he responded 'it's too soon to tell'. That applies to the current situation. But we could be looking at $6 trillion in mark downs of housing wealth, $3-4 trillion in stock market losses if we get a 25-35 percent mark down in the market - and it could be worse - and then we have the losses of the banking system. So we are talking about possibly $10 trillion as compared with a GDP of $13 trillion. Proportionally, I would look for the UK to suffer similarly. It's not chicken feed!

Marc: Right from the start my estimate of the losses was about USD 1 trillion in the US alone. However, if we add the losses from a decline in housing wealth and stock market wealth the losses are a multiple of that.

Ernest: Overall, the fallout could easily be in the many trillions of dollars. No-one really knows (especially central banks and finance ministries) – but if we quickly add some basic financial areas where there are already are losses to those we can expect it is easily 2-3 trillion.

The two US mortgage backers losses are in the trillions – the loss to the 10 million privately owned real estate homeowners is also in the trillions. When you estimate in the range of a US$ 250 billion loss in each of the following sectors – equities,

consumer debt instruments (such as car loans, credit cards and student loans which have also been repackaged and sold as asset-backed securities), corporate bonds, specialized insurance companies which guaranteed bonds and mortgages to collateral mortgage instruments, the loss in tax revenue to states from real estate taxes, the bankruptcy of a major broker whose revenue has been based on charging fees rather than earning income from addressing and dealing with credit risk, the bankruptcy on one or more hedge funds, construction company losses and bankruptcies of and derivatives, it will be a multi trillion dollar loss.

Anthony: Do you think that inflation or deflation is the greatest threat facing the global economy - i.e. commodity price inflation versus the collapse in asset values (real estate and stocks etc).

Marc: We are in the midst of an unprecedented credit growth slowdown and this will hit all asset classes - one after the other, as liquidity tightens up and as de-leveraging becomes the order of the day. First home prices came down, then financial stocks and now commodities, material and energy stocks, and art prices will follow. Bonds will eventually also tumble. In the meantime it is likely that consumer price inflation will accelerate.

Mark: In view of aggressive monetary expansion by the US, the risk of inflation is probably greater. In emerging markets, another big risk is also the abandonment of the market economy philosophy and a cessation of privatization of state owned companies.

Bill: This is the great debate. The losses are deflationary but the monetary and fiscal policies are hugely inflationary. So far the secondary effects of wage inflation are the dogs that have not barked yet, but the unions are clearly getting restive in Europe and the pressures are so intense on US wage earners that it surely must just be a matter of time before they try and restore some of their lost incomes.

Ultimately, governments never repay their debts in real terms. I look for the US to try and inflate its way out of its mess whilst, all the time, denying it is happening and quoting the manipulated inflation data. But one only needs to look at the private estimates of M3 growth to see that it has been growing at 18 percent per annum, double what it was when they stopped publishing the information and double the worst time in the stagflationary 1970s.

Ernest: Probably inflation initially. But as the avalanche builds and recession hits oil-importing countries, the combination of a severe US recession and a global slowdown will shift the focus away from inflation to the slipping demand for real goods which will lead to a reduction in prices when supply exceeds demand. There will be downward pressure on labour markets, rising unemployment, while at the same time commodity prices fall in accordance with reduced demand. Equity market prices are presumably based on value, while commodity market prices are the result of supply and demand.

As the Fed approaches a zero interest rate policy, its ability to have an impact on the economy will be reduced. This is because the Fed has been playing a bigger role in financial stability issues rather than growth issues.

Anthony: How safe is US government debt as an investment now, given the stress of financing financial system bail-outs?

Ethan: It is absurd to think that US government debt is not "safe." The potential liabilities the government is taking on are small relative to the size of government debt and even in a worst case scenario, debt as a share of GDP is unlikely to approach the highs of the US 15 years ago or in other major economies such as Japan and Italy. Moreover, the Fed earned its lesson from the 1970s and is very unlikely to allow a sustained inflation acceleration.

The big challenge for US debt is not new: it is the huge surge in costs as the baby boom generation retires. In terms of the dollar, it is also wrong to focus on US government liabilities. What matters to the dollar is the overall borrowing requirement of the economy–that is the current account deficit. The current account deficit is improving as exports surge and imports stagnate. The deficit is still too big, but at least it is moving in the right direction. Looking ahead, further improvement is likely as Americans rediscover the virtues of conventional saving, rather than relying on asset price appreciation to accumulate wealth.'

Marc Faber: A big risk of meltdown of the (US) financial system.

Mark Mobius: A water-torture bear market has begun.

Ernest Kepper 'I say this is an avalanche.

William Thomson: In no way can this be seen as a normal bear market.

Ethan Harris: It is absurd to think that US government debt is not safe.'

Marc: Since the government can print money US debt is 100% safe. What is, however, not safe is the US dollar. So, investors may eventually get their money back in a currency - the US dollar - which will hardly be worth anything.

Mark: Looking at the U.S. fundamentals, the perceived safety of U.S. government debt is under stress which is why central bankers have been diversifying their reserves. Of course in a general loss of confidence then such debt could become risky.

Bill: You will be repaid in US dollars with less purchasing power than when you subscribed. Whilst this crisis continues and the management of the White House and the Fed remain unchanged, the US dollar is a poor bet and a worse investment.

Ernest: While US. Treasuries have not been particularly rewarding buys, mainly

because of excessive debt loads, it is default swaps and derivative products plus counter-party risk management instruments and arrangements on the market by foreign countries that raise concern.

Anthony: What is the safest thing to "hold onto" in this avalanche - gold, other commodities, cash etc?

Marc: For the next three months the US dollar should be fine. On weakness physical gold should be bought as it is the only "honest" currency. I would avoid industrial commodities. Farmland and plantations should also be relatively attractive.

Mark: I would still maintain that the best strategy would be to have a diversified portfolio between equities, bonds, commodities and cash. We continue to find fundamentally stock companies trading at attractive prices as a result of the global market correction.

Ethan: Investors should remain conservative in this environment. Even commodities are not a panacea. For example, the surge in oil prices in the face of a clear weakening in oil demand, suggests part of the run-up this year is unsustainable.

Bill: Gold, in my opinion, is the asset of last resort. It is no one else's liability and has shown its value in crises over the millennia. That situation remains unchanged. It is still cheap relative to oil on a historical basis and is only 40 percent of its all time high on an inflation adjusted basis. New supplies coming onto the markets are constrained by high costs and a lack of mining skills after a generation when no new graduates entered the sector.

Given the global geopolitical tensions added to the banking crisis, gold remains a superb insurance policy. Before the present cycle exhausts itself I would not be surprised to see gold reach all time highs on an inflation adjusted basis i.e., $2500. Silver is also interesting here since it is a minor precious metal with expanding industrial applications. On an inflation adjusted basis it is even cheaper than gold. There are an ever expanding range of instruments to tap the commodity space with ETFs and ETNs - long and short. There are also natural resource funds of hedge funds.

Anthony: Amongst equities and bonds, what (if anything) is there to go for now? Emerging markets versus advanced markets?

Marc: I think for the next three months the US will continue to outperform emerging markets - as it has done already this year - and this not because the US market went up but because it went down less than emerging markets. I also think that Japan will outperform the US and other markets. High yielding equities in Asia, including Singapore REITs, should be okay but up-side potential is limited.

Mark: There's always something to buy. While global growth is slowing down and inflation has been increasing, emerging markets are still expected to grow at a

much faster rate than developed markets. They, thus, representing an investment opportunity. Moreover, 'frontier' markets [those at an earlier stage of development than established 'emerging' markets] are also looking interesting.

Bill: I believe we are entering a new phase in the global economy, one with increased government regulation, controls and spending. The old Thatcher-Reagan supply side revolution is likely to take a breather and a return to modified Keynesian policies is a possibility.

This is driven by the increased scepticism in developed economies about globalization, largely because the rewards have not been adequately distributed. This accords with the likelihood that the 36 year cycle in US Presidential elections will probably make the Democrats the leading party of government in the coming years with all that means for interference in the economy - and inflation.

The extent to which the growing scepticism of globalization in developed economies affects the future growth of emerging markets cannot be determined at this time. At the margins growth may be reduced slightly but the fundamental factors changing the shape of the global economy are too strong to be derailed. Emerging markets remain a field of great opportunity, especially after recent declines in countries like China, India and Vietnam. Others with essential commodities are exciting. Powered by Chinese and Indian investment, Africa could have a renaissance. Those with financial imbalances like those in Eastern Europe should be avoided.

KEY POINTS

This is the worst financial crisis since the 1930s and equity prices have more room to fall.

All told, the total losses could run into trillions of dollars.

High inflation is likely to persist, at least for some months.

Investors can seek refuge in precious metals and selected emerging markets.

William R. Thomson

Chairman, Private Capital Limited, Hong Kong

wrthomson@btconnect.com

1 August 2008

Copyright 1999 - 2008 Le Metropole Cafe. All rights reserved.