

Feel the Elephant

There is a parable about the human condition that is particularly apropos for investors in the current investment climate characterized by high volatility and great uncertainty. Five blind men walking through the jungle stumble on an elephant. But of course they don't know it is an elephant because they are blind. One feels the tail and says it is a snake. One feels the side and says "No, it's a wall." Another feels the tusk and thinks it's a spear. Another thinks the ear is a large leaf.

Like the blind men, our information set is fundamentally and irrevocably incomplete. Yet we nevertheless have to make judgments and decisions. So with that caveat, let me tell you about the part of the elephant that I am feeling here at the start of 2009.

Financial Crisis Eases

Let's begin with the crisis. The severity of the financial crisis shows numerous signs of easing. Of course, it took significant action and demands continued vigilance by numerous countries. Many of the largest financial institutions in the G10 remain on life support provided by governments through capital injections, asset transfusions (swaps), and insurance (guarantees). Parts of the capital markets that had been paralyzed have begun seeing business. There is still more work to be done, using medicines of both a monetary and fiscal nature, but the therapeutic regime is understood now in a way that it may not have been since the crisis first broke in the summer of 2007.

While the intensity of the crisis, which was aggravated by failure of Lehman, has eased considerably, and there appears to be some marginal return of risk taking, major economies are experiencing a severe contraction and many developing countries are slowing down dramatically. The economic environment has financial market implications, even if there hadn't been a financial crisis. For example, with rising levels of unused capacity, there is even less of a reason for businesses to borrow to expand plant or equipment outlays. Similarly, with the household net worth being crushed by the combination of the decline in house prices and financial asset prices and job insecurity growing with rising unemployment rates, households have little choice but to retrench.

No Repealing Economic Laws

The economic entrails point to a severe contraction in Q4 08 and the leading indicators point to continued weakness in Q1 09 as well. The US economy appears to have contracted around 5% at an annualized pace in Q4 08. This could represent the sharpest part of the contraction, but things might not feel much better in the current quarter with a contraction of around 2-2.5% anticipated.

There are reasons to be more optimistic in the second half of the year. The aggressive orthodox and non-orthodox monetary policy steps, coupled with the large scale fiscal measures, will have a positive impact on economic activity. It always has. Some observers have suggested that it was WWII that brought the US (and world) out of the Great Depression. Yet a budding recovery was in fact taking place, fueled by fiscal stimulus, but at the first sign of green shoots, politicians lost their bottle and took away the punchbowl prematurely and the economy slumped again.

There was another economic force that weighed on numerous national economies last year, but is now overshadowed by the focus on the financial crisis per se. This is the spike in commodity prices. The fact that gasoline prices and food prices have fallen sharply which should bolster disposable income is largely ignored by those observers feeling a different part of the elephant. Ultimately, businesses, households and investors respond to economic incentives. Anecdotal reports suggest the drop in gasoline prices is spurring increased activity in auto and SUV showrooms for example.

The notoriously indebted American family is reducing its leverage. There are two essential dimensions to this. The first is personal income is rising faster than consumption. The official measure of savings is rising and will

likely continue in the period ahead. The second dimension of household de-leveraging appears to even more significant than boosting household savings per se and that is the rising tide of residential foreclosures. If, for example, 5% of the \$14 trillion mortgage debt market were to default, that would reduce the liability side of the aggregate household balance sheet by \$700 bln.

Imbalances?

Some observers, like the esteemed Economics Editor of the Financial Times Martin Wolf, insist that the part of the elephant that they are feeling is the source of all that is bad with the world, economically speaking: "the interplay between persistent external and internal imbalances in the US and the rest of the world (7Jan 2009 Financial Times)." But the part of the elephant I am feeling has a role for Hyman Minski and the idea that a long period of financial stability breeds what he called "balance sheet engineering" ultimately producing financial instability. It also identifies a significant role for leveraging, which cannot simply be reduced to the infamous imbalances, which appear to be at least in part an attempt to solve other problems.

The part of the elephant that I am feeling suffers from malnutrition. It is not that it is not consuming (sufficient calories or goods) but the wrong kind and in the wrong way. It has not been fueled by wage and salary growth. Indeed since the early 1970s, wages and salaries have been decoupled from inflation and productivity.

So how does the average household (not the investment banker, entertainer or athlete) make ends meet? The hours worked by the household as a whole has gone up over the last several decades, as women increasingly entered the workforce and teenage children increasingly work as well. And of course credit was increasingly used as well. The moralists among us demand that households (and government) live within their means. The part of the elephant I am feeling concurs, but does not accept those "means" as given and instead sees moral issues in how those means are determined.

The part of the elephant that I am familiar with also insists on a role for policy, such as the 2004 decision to allow brokerage firms to dramatically lower their capital reserves, or the changes in bankruptcy law that provided households with a clear incentive if forced to make a choice to pay down credit cards and default on mortgages. Unlike in Wolf's inspection of the elephant, mine has a role for individual responsibility. The originate-and-distribute model is fundamentally flawed. This has nothing to do with global imbalances, and every thing to do with institutional incentive structure.

The Dollar

Where does this leave the US dollar? Many currency analyses are based on the kind of external imbalances that Wolf speaks of so eloquently. But this does not appear to be the driving force of the foreign exchange market. Indeed as the US current account deficit improved farther and faster than expected in the H108, the dollar remained weak.

I generally place more emphasis on interest rates (including differentials, slopes of curves and the like). Yet as the Federal Reserve eased monetary conditions aggressively in H2 08, the dollar screamed higher. And the one currency that was even stronger than the dollar, the Japanese yen, had even lower interest rates.

With the benefit of hindsight, leveraging played a big role in the dollar's decline and de-leveraging played a big role in its recovery. The depth and breath of the US dollar market and low interest rates (of which only the short-end is directly influenced by the Fed) provided a vast pool of financing. While much ink was spilt about the yen carry trade, the 8000 pound elephant was the dollar carry trade.

This year the dollar may be driven by neither leveraging nor de-leveraging activity. Instead, the dollar may be embraced as a growth story. The aggressive actions by the government and central bank coupled with the drop in oil prices increase the likelihood that the US emerges from the dire financial conditions first. It is this expectation that underpins the medium term constructive outlook for the greenback.

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