The Contrarian Case

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Editor: Bill Julian
Email: bill@julianresearch.com

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Last we checked, virtually every Wall Street economist is predicting that the yield on the ten year Treasury bond will rise over the coming years. We think it may continue to fall and that the bond bull market still has life in it. Add the view that the valuations of US equities will continue to fall over that period (the equity secular bear market continues), and you have THE contrarian call.

When all is said and done, there is precedent in the historical record to support the case that five years from now, the ten year treasury bond could be priced to yield 2% - 2.5% and the S&P500 could be priced at an 8 – 10 P/E ratio. This is heresy, by the standards of most investment strategists, because this goes against the conventional FED model that says as bond yields fall, P/E ratios should rise. I would argue that may be the case in an economy where monetary policy is still effective and the appetite for borrowing and lending remains healthy, but that is not our economy any more.

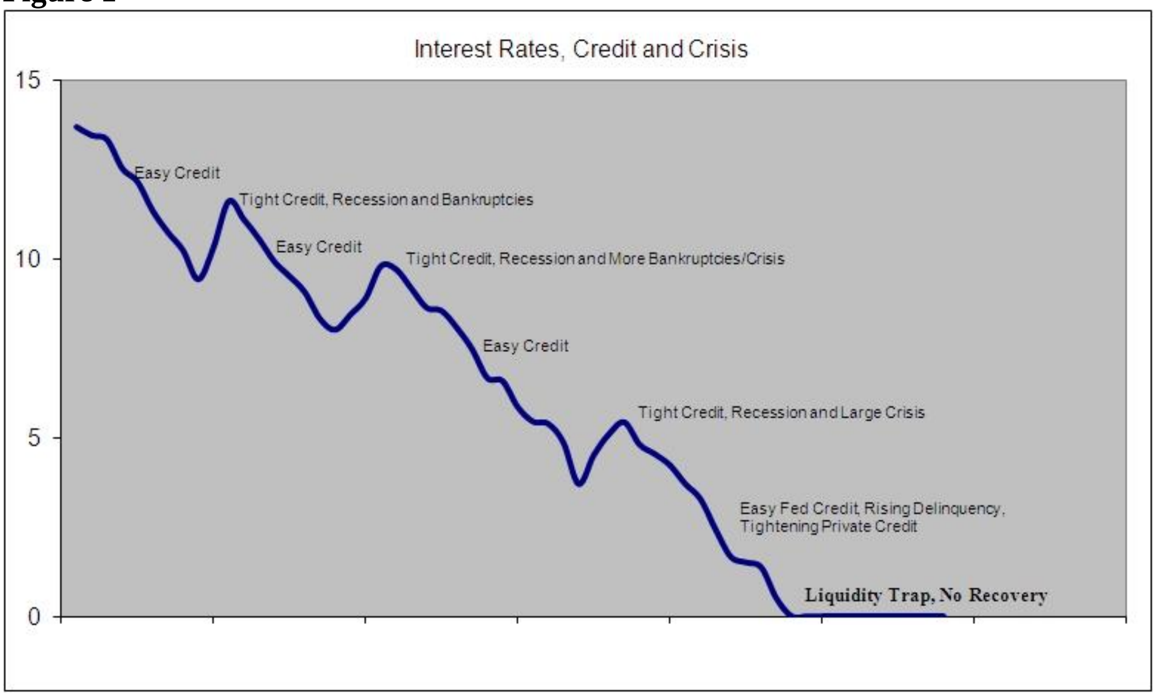
QEII is about to end, the economy is sputtering, and everyone is a-twitter about what happens next. QEII was a skirmish in the titanic battle between the unstoppable tsunami of Fed-induced monetary inflation the immovable wall of debt deflation. We think the next five years will be full of the same sorts of policies followed by similar mediocre economic performance. Bouts of monetary stimulus and fiscal stimulus will make things look better, and then dry spells will tip the economy into recession. Against that backdrop, we look at two historical analogies. One is dominated by inflationary pressures and the other by deflation – but the outcome for asset prices was the same: a very expensive long bond and cheap equities. The two analogies are deflationary Japan since the 1990s and the inflationary US in the 1940s and early 1950s.

Finally, at the tail end of this report we pass along the thoughts of two of our favorite strategist on the matter of short-to medium - term equity performance – Russell Napier and Jeremy Grantham. They think the top is in.

QEII Has Failed Fails to Break Us Loose of the Liquidity Trap

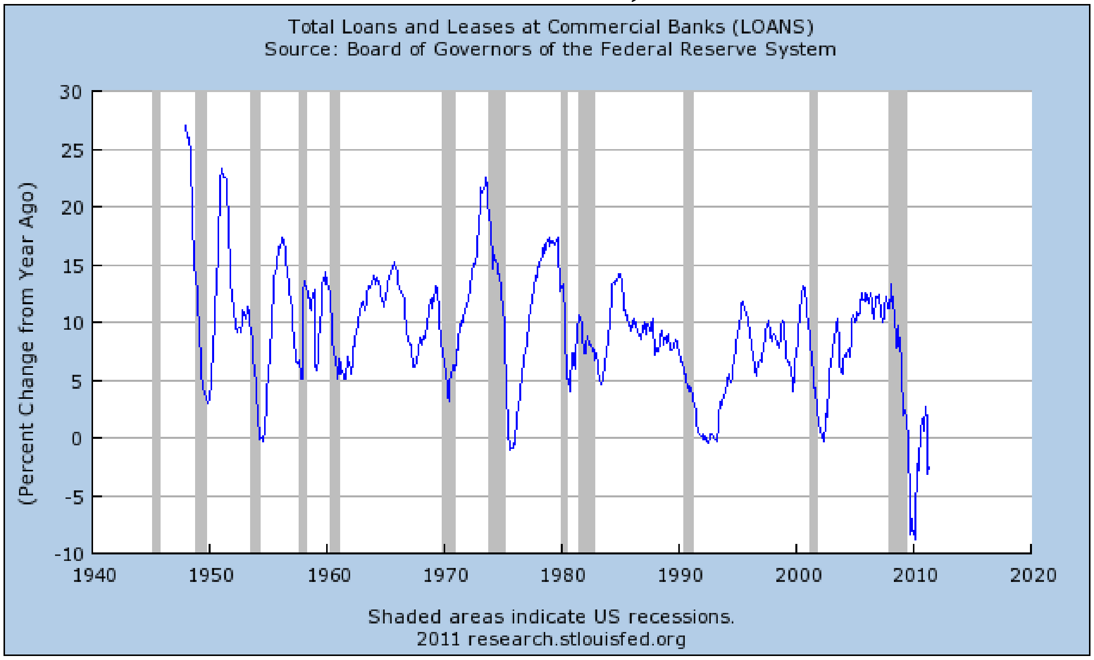
To jump-start an economic recovery, the Fed tries to get money into the hands of people that will spend it. Historically it has done this by spurring lending and borrowing activity with lower short term interest rates. The trouble today is that rates are at zero but incremental borrowing and lending is just not happening. It's as if the gear box is stripped -- the FED is revving the engine but the wheels aren't turning any faster. This is a classic liquidity trap (figure 1 is an idealized narrative of how we get into a liquidity trap).

Figure 1



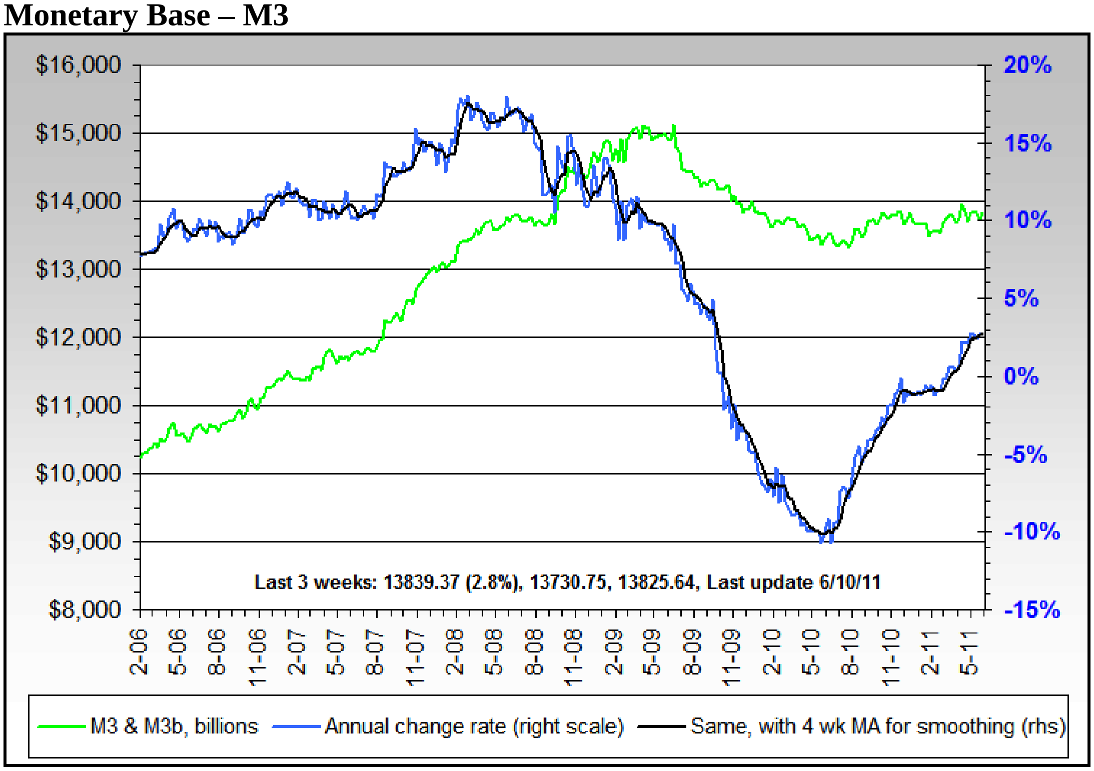
QEII was supposed to break us free of this trap, by reducing interest rates at longer maturities, but so far it has fallen well short of the mark. Figure 2 below shows total loans and leases at commercial banks grew only briefly in late 2010 and have since contracted again. M3, the broadest definition of money that includes credit creation, is still well off its peak of 2008 and is no higher than it was when QE2 was instituted. (The green line in Figure 3 below is a proxy for M3.) This is unprecedented and is consistent with the current flurry of poor economic data. It is almost certainly a huge disappointment to the FED.

Figure 2
Total Loans and Leases at Commercial Banks, Year-over-Year Growth



Source: Board of Governors of the Federal Reserve System

Figure 3
Monetary Base – M3



Source: Russell Napier: "QE2 Fails – Sell US Equities"

Monetary policies simply don't carry the punch they once did. This is common in the aftermath of a credit binge. For an in-depth discussion of the subject we suggest our report from April 2009, entitled "Debt Fatigue: The One Big Lesson From Japan", where we outlined how the debt overhang would seriously blunt the Fed's monetary policy tools and slow future economic growth. So now what does the Ben Bernanke FED do next?

The Bernanke FED: If at First You Don't Succeed…

One can get a good sense of how Ben Bernanke thinks about his job at the Fed by looking at his papers and speeches. Two conclusions emerge. First, he believes monetary policy, properly conducted, has the power solve most economic problems. Second, he believes increasingly aggressive and unconventional policies should be used if the last policy didn't work – in a never-ending loop – until something does work. In a 1999 paper titled "Japanese Monetary Policy: A Case of Self-Induced Paralysis?" he blames Japan's problems on "exceptionally poor monetary policy", and prescribes an aggressive depreciation of the yen. From this paper:

> Suppose that the yen depreciation strategy is tried but fails to raise aggregate demand and prices sufficiently, perhaps because at some point Japan's trading partners do object to further falls in the yen. An alternative strategy, which does not rely at all on trade diversion, is money-financed transfers to domestic households—-the real-life equivalent of that hoary thought experiment, the "helicopter drop" of newly printed money.

Clearly Ben is willing to be aggressive – but more importantly, consider the title of his paper: "Japanese Monetary Policy: A Case of Self-Induced Paralysis?" The entire point of his speech was less about his policy ideas than the reluctance of the Japanese to implement aggressive policies because some of them were viewed as stepping beyond the legal scope of what the Bank of Japan was designed to do. His advice: doing something is better than doing nothing, and where there is a will there is a way. He invokes Franklin D. Roosevelt in support of this view. From the same paper:

> Franklin D. Roosevelt was elected President of the United States in 1932 with the mandate to get the country out of the Depression. In the end, the most effective actions he took were the same that Japan needs to take—-namely, rehabilitation of the banking system and devaluation of the currency to promote monetary easing. ***But Roosevelt's specific policy actions were, I think, less important than his willingness to be aggressive and to experiment—-in short, to do whatever was necessary to get the country moving again (emphasis added).*** Many of his policies did not work as intended, but in the end FDR deserves great credit for having the courage to abandon failed paradigms and to do what needed to be done.

Whether or not you agree with his assessment of FDR's performance is irrelevant. What is important is what all of this says about Bernanke's mind-set. Bernanke will use any unconventional tool he thinks might work and he will not be afraid to topple any obstacles that stand in the way of their implementation -- because the end goal of "getting the country moving again" justifies any and all means.

Against this backdrop, it's easy to see that the Bernanke Fed will try again and again. It is probably just a matter of time and of sufficient deterioration in the economy and asset markets. Speculation on the shape and name of QEIII is already rampant. David Rosenberg, Chief Economist at Gluskin Sheff (formerly Chief Economist at Merrill Lynch), sums it up nicely:

> Politically, the Fed has to wait for the next downturn in economic activity and reversal in the stock market so that those on Capitol Hill that are lamenting the Fed's interventionist efforts end up begging for more. This could come sooner than you think, but likely not until we see the whites of the economy's eyes — and early signs are showing a visible sputtering in growth.

The Fed's Next Move: Back to the 1940s?

Bill Gross tweeted this week that the Fed's next move could be to cap the interest rates on 2-3 year treasuries. If he is right, it will be like announcing QEIII through QEX (QE ten) all at once. It would be an open-ended promise to print as much money as needed to buy as many 2-3 year bonds as needed to cap those rates.

Ben Bernanke has already expressed his preference for such a policy. Bernanke is a disciple of Milton Friedman. This policy is consistent with Friedman's theory entitled the "permanent income hypothesis" which postulated that it is changes that are deemed permanent, not temporary, that induce a permanent change in economic behavior. From his famous speech in 2002, *Deflation: Making Sure "It" Doesn't Happen Here, (*speech to the National Economists Club, Washington, D.C., November 21, 2002):

> A more direct method, which I personally prefer, would be for the Fed to begin announcing explicit ceilings for yields on longer-maturity Treasury debt ... Lower rates over the maturity spectrum of public and private securities should strengthen aggregate demand in the usual ways and thus help to end deflation. Of course, if operating in relatively short-dated Treasury debt proved insufficient, the Fed could also attempt to cap yields of Treasury securities at still longer maturities.

Believe it or not, the US has been there before. In the 1940s, the Fed fixed yields on government debt for nearly a decade, in part to fund WWII and its aftermath. From the same Bernanke speech:

> Historical experience tends to support the proposition that a sufficiently determined Fed can peg or cap Treasury bond prices and yields at other than the shortest maturities. The most striking episode of bond- price pegging occurred during the years before the Federal Reserve-Treasury Accord of 1951. Prior to that agreement, which freed the Fed from its responsibility to fix yields on

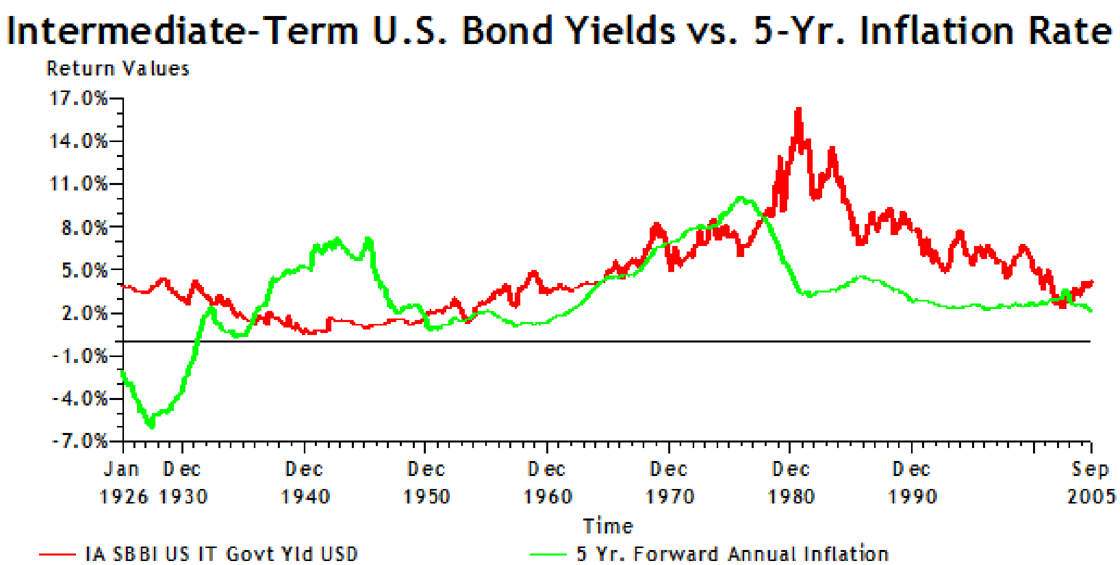
government debt, the Fed maintained a ceiling of 2-1/2 percent on long-term Treasury bonds for nearly a decade.

Bernanke believes he has a lot of ammunition left, and you had better believe he will use it just as soon as he thinks it necessary.

Five Year Outlook for Bond and Equity Prices

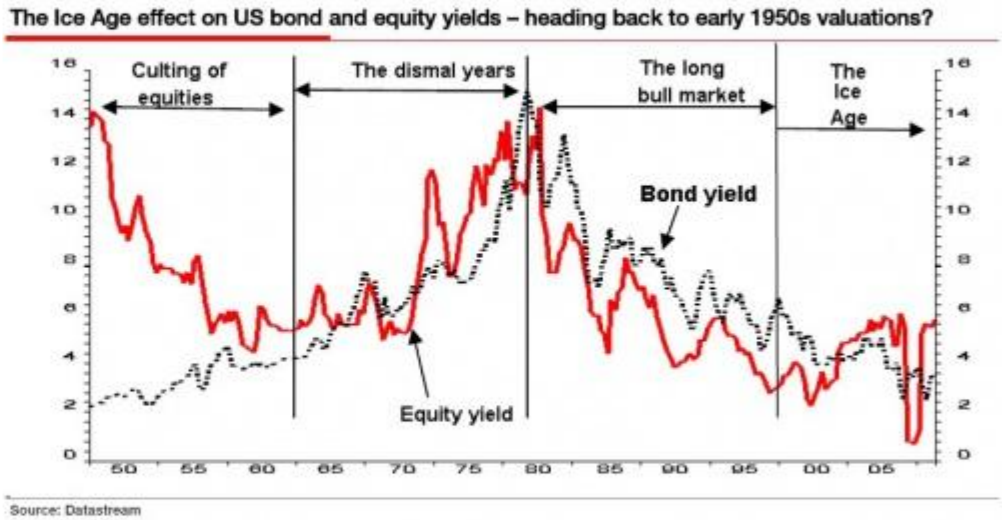
This is where the experience of the late 1940s starts to challenge conventional thinking about asset prices. First, the entire decade was very inflationary, yet as figure 4 below shows, interest rates stayed below 2.5%, because the FED kept them there. This argues that the FED has the power to manipulate the bond market completely, if it wants to, and that interest rates will not necessarily rise if inflation picks up over the next few years. The common refrain is that with increased inflation, the Chinese will eventually demand higher interest rates to buy our bonds. That may be true, but what difference does that make if the FED will buy them at a guaranteed low rate, like they did in the 1940s?

Figure 4



Second, the relationship between equity prices and bond prices do not necessarily follow the FED model. Figure 5 below shows that equity yields ended the 1940s at 14% (P/E of about 7x), while long bond yields sat at 2.5% -- the very thing that many strategists say is impossible. So if inflation picks up between now and 2016, and the economy continues its sub-par performance (which we fully expect) we could very well find equity P/E ratios slipping back toward single digits to reflect stagflation, while treasury bond yields don't move much because the FED simply won't let it happen.

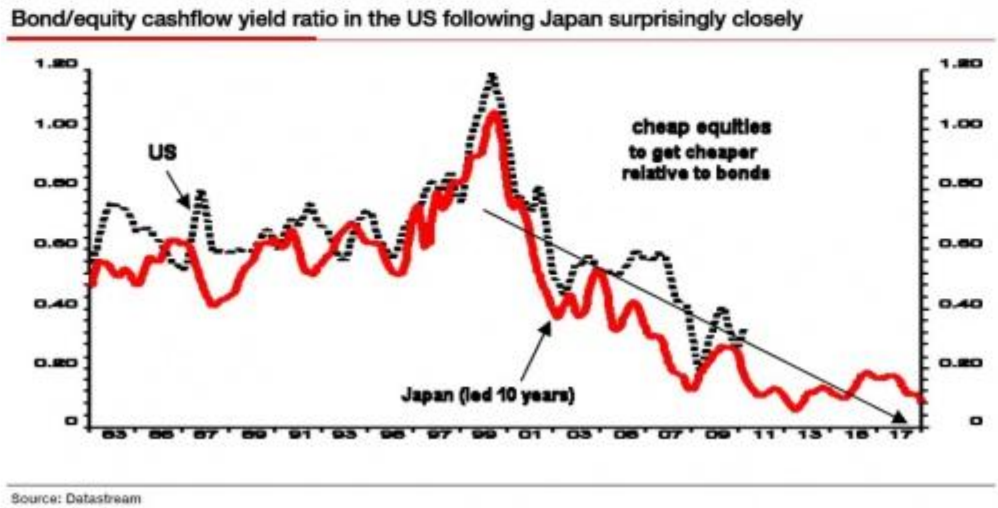
Figure 5



The Japanese experience with asset prices has been similar, although the backdrop has been more deflationary than inflationary. In that environment bond prices remained high without help from its central bank (reflecting deflation), but equity prices gradually fell as it became increasingly apparent that growth is simply not going to resume at a pace fast enough to support anything but below average equity valuations. Albert Edwards, strategist at the French bank Société Générale, coined the term “IceAge” to describe the long, unexciting financial and economic slog that follows every credit bust. He thinks the Japanese experience is a very good model for what lies ahead in the US. His terminal target for the S&P500 at the end of this secular bear is 400. Not a typo. At the same time, he sees the US Treasury long bond rallying the entire time to the point where yields of 2% on the ten year will be common.

The most compelling chart Edwards uses to startle his clients into seriously considering this outcome is detailed in figure 6. It charts the ratio of bond yields to equity yields. When the lines are falling, equities are getting cheaper relative to bonds, meaning the P/E ratio is falling while bond yields stay the same, for example. Edwards then superimposes the US experience over the Japanese experience with a ten year lag. The chart speaks for itself and points out that the US is following the Japanese experience surprisingly closely. Since Japan started down this path ten years before the US, he argues, we can look forward to another decade of Ice Age "derating" of equities – equity P/E’s falling while bond prices keep rising.

Figure 6



Our view is that the US experience will be more like that of Japan, because the backdrop of debt burdens and demographic trends looks more like Modern Japan than the US in the 1940s. But the Bernanke FED will be more aggressive than the Bank of Japan has been, so we can expect more economic fits and starts, more bouts of inflation/deflationary scares. The end result for bond and equity prices is unlikely to be any different because the economy remains crippled under a massive load of debt. How could we be wrong in this analysis? Our key assumption is that sub-par economic performance, created by our heavy debt burden, will persist for the next five years, in spite of any fiscal or monetary actions. If we are wrong about this and the economy performs better, then our view of asset prices will be wrong.

Napier, Grantham, Call the Top for US Equities

In our opinion, there are two strategists that have done an excellent job of anticipating turns in this long secular bear market: Russell Napier and Jeremy Grantham. Both of them called for tough times in the summer of 2007 and 2008, both of them turned bullish near the bottom in 2009, and now both of them are arguing that the risk reward has deteriorated so much that it simply makes no sense to stay long stocks at this point.

Russell Napier's view has been that the heart of this secular bear market in stocks would begin when the Treasury bond market sold off in earnest, in anticipation of much higher inflation. In his recent report entitled "QEII fails - Sell US equities", he changes the course of his narrative: because the FED has failed to create conditions for lasting, persistent inflation that would start the sell-off in treasuries, he is now arguing that the risk of deflation is again a serious problem. Of utmost concern is the credibility of the FED following this failed policy. While one can debate the timing, the look and the name of QEIII, he feels sure it will come, but he is not convinced that it will work any better than QEII and the risk is that the market will also anticipate its failure and not respond as favorably as it did to QEII. Adding my own comment to this narrative: if the S&P500 finds itself back at 1000 when QEIII is announced, I suspect we would see another rally -- but to Napier's point it is not clear whether it would be enough to push the market to new highs.

Jeremy Grantham's narrative had been that the markets would hold up until this fall, which coincides with the end of the strongest seasonal period on record, the third year of the presidential cycle. (On average, equities advance 15.5% from September to September, and since 1932 have never posted a negative return in this period.) He believed the S&P500 might make it into the 1400 to 1600 range by then. Now, his view is that without a QEIII in short order, "there seem to be too many unexpected (indeed unexpectable) special factors weighing against risk-taking in these overpriced times." By unexpectable special factors, he means everything you've been reading about in the news. As an aside, I have a sneaking suspicion that very few of the models that drive modern finance have any factors that correctly reflect political risk. Models are built on historical data, by definition, and there is little data that dates back far enough to encompass serious political instability. This suggests that Wall Street's next black swan may swoop in from the political sphere. Back to Grantham --

> Risk now should be more reflective of an investment world that has stocks selling at 40% over fair value (about 920 on the S&P500) and fixed income, manipulated by the Fed, also badly overpriced... **And whether (the S&P500) will reach 1500 or not, the environment has simply become too risky to justify prudent investors hanging around, hoping to get lucky. So now is not the time to float along with the Fed, but to fight it.**

A friend of mine who has been kind enough to slog through all of my reports over the years asked me last week: “so when is Armageddon coming?” Believe it or not, I was surprised – I thought to myself, do I really sound like one of those guys walking the streets of New York with a sign draped over me saying “the end is near!”? At the risk of sounding defensive, I think the right analogy is more that of a weatherman saying winter is coming. While that may be depressing, winter is not the end – instead it sets the stage for spring. (You see, I’m really an optimist at heart.) So, how would I answer the rephrased question: “when will winter get here?” It’s here, but some of the coldest days probably still lie ahead. How do I know this with certainty? I don’t, except that it would be an unusually mild winter compared to the others on the historical record if the worst was behind us and spring was already on its way.
