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REMEMBERING THE FUTURE
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From the Port of Hope to the Harbor of Despair: An Overview of the Global Landscape

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Introduction

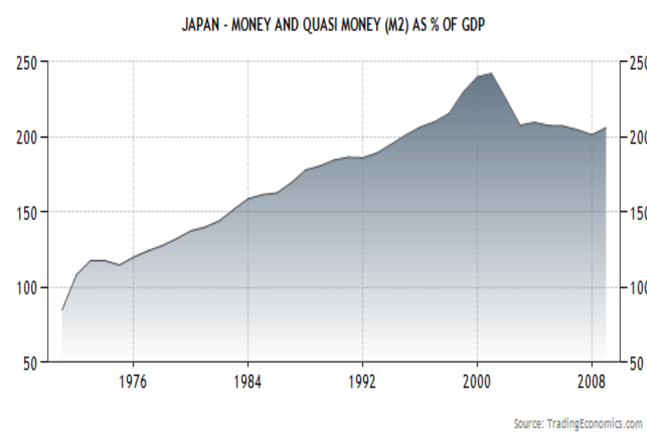
A few days ago we wrote in a weekly commentary that markets could implode from within creating black holes where everything goes in and nothing comes out. Real economies may be destroyed as paper wealth in the process. The essence of Gamma Ray Bursts (GRBs) is that explosions could take place when a star collapses and forms a black hole.

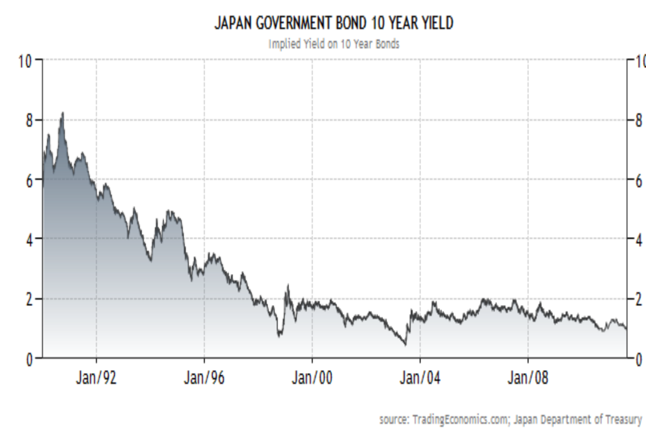
The markets' gyrations and volatility might be a prelude to a transition that will shift global structures and in the process will form waves of instability. The long term should be viewed through the eyes of the medium term, and the latter through the lenses of the short-run. Hence, here is what we may experience on a global scale in the next few weeks: Political and monetary maneuvering may uplift the moods of the market and we may experience a temporary lift up in the equities markets. Given the fact that the fundamentals (debt, growth, employment, productivity, prospects, confidence, profitability, margins, toxic assets, questionable balance sheets, exhaustion of tools to fight stagnation, etc.) are pretty weak, the reversal is to be expected soon thereafter. The reversal may be accompanied with upward trends in precious metals, demands for safe havens, significant downward pressures in equities, risk aversion, currency uncertainty, and political stalemate.

Let's then take a helicopter view around the globe and see what is happening.

Asian Developments

Japan elected last week its sixth Prime Minister in five years. It is probably seeking to break the old Italian record of turning over PMs every year. The Japanese stagnation is the outcome of credit explosion that created bubbles, unstable financial institutions, and toxic assets in the 1980s. The hangover from that experience pushed the debt higher, brought in financial repression in terms of lower yields and depressed the equities markets. The figures below tell us the Japanese story.

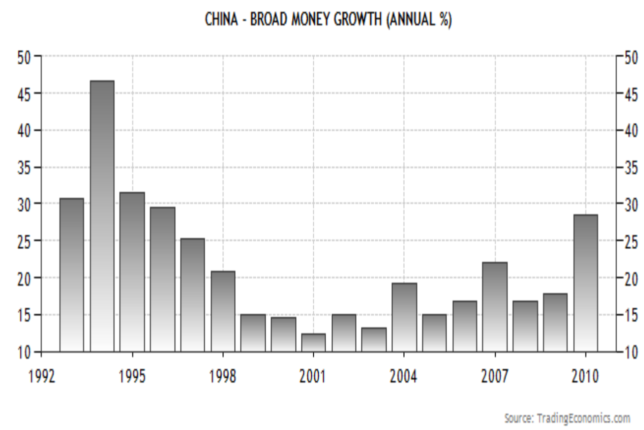


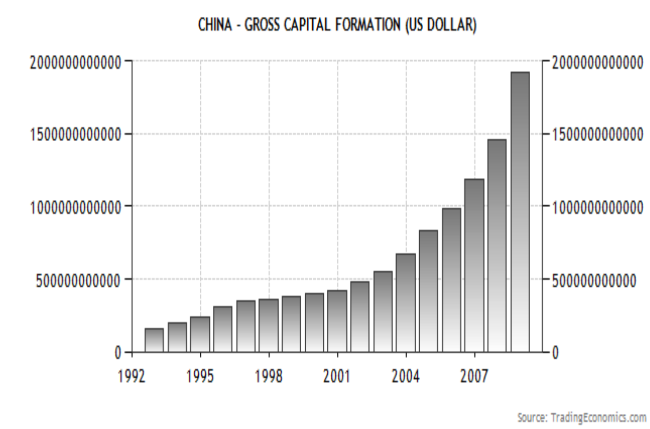


Would we be surprised if the Japanese economy experiences an even worse hard landing scenario in the next 4-5 years? No, actually the chances are that given the global landscape the Japanese economy will get worse.

The story in China, as we know well is the opposite of Japan. China took advantage of its comparative advantage in low wages and used the export-led model to experience significant growth and prosperity. The figures below summarize that story:

While the Chinese were building their economy they could tolerate significant money-stock increases, as shown below, given of course that the money was used for productive purposes in terms of enhancing the export-led growth model and contributed to higher productivity levels which was the case up until the financial crisis. However, since 2008, the Chinese money growth (reaching almost 30% in 2010, see figure below) is backing up projects (see gross capital formation graph below) whose NPV is questionable and hence the major delays in loan repayments. Moreover, their real estate market and infrastructure spending has reached a plateau, and thus as we wrote previously, we would not be surprised if we start seeing bubbles in China start bursting. Indicative of that is the interbank loan rate, also shown below.





Shanghai Interbank Offered Rate

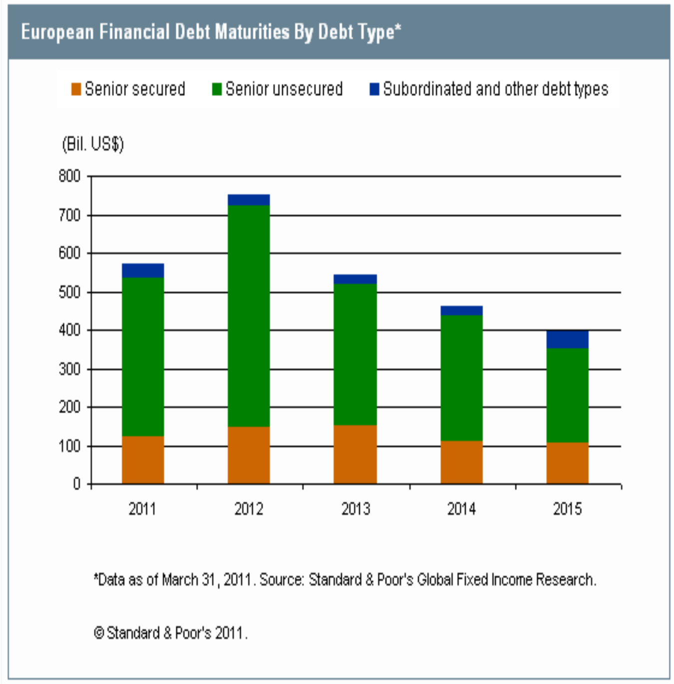
The interbank rate in China has more than doubled in less than a year. We believe that the Chinese currency will strengthen in the midst of the predicted tidal shift and a small allocation in RMB is warranted at this stage, while shorting the Chinese market might also turn out to be profitable.

Speaking of currencies in that area of the world, we have previously commented and actually allocated a small portion in Australian dollars. However, with the expected tidal sift and the Chinese slowdown, we consider the Aussie dollar a bit overvalued and hence, we have a negative outlook for it.

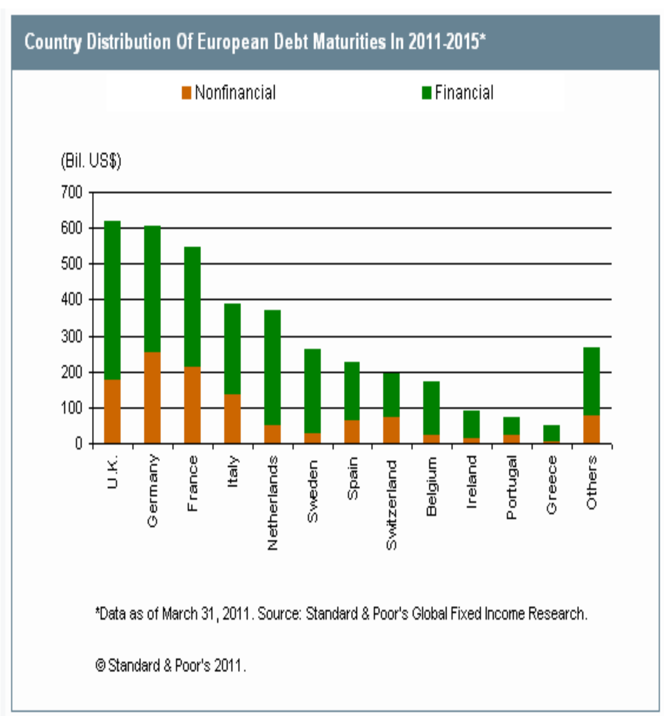
<u>**European Developments**</u>

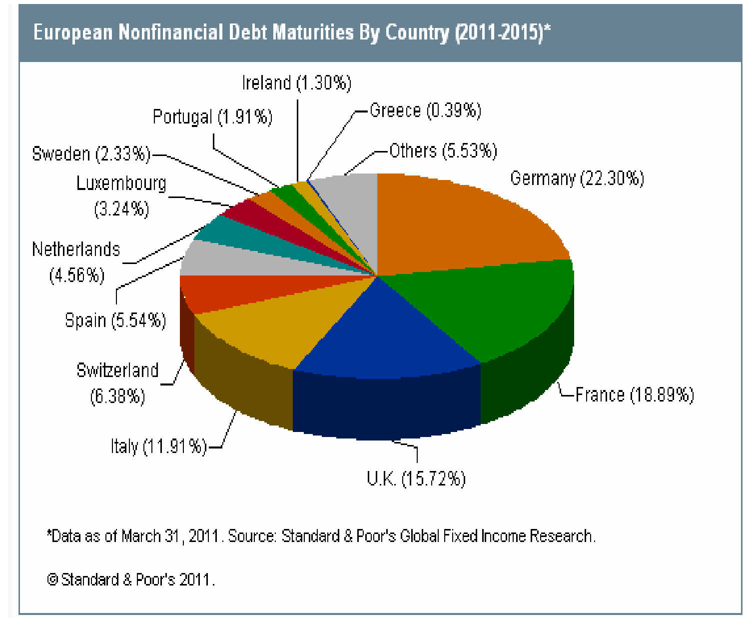
The EU problems are pretty much well-known. Overextension of credit, wide-spread toxic assets, accumulated and growing deficits that led to unsustainable debts, uncompetitiveness, unemployment, undercapitalized banks, leaderless institutions, lack of vision, etc. The graphs below, point out some of those problems.

We will start with the amounts of unsecured debts issued by EU financial institutions that will need to be refinanced in the next 2-3 years. As the figures show, the amount exceeds $4 trillion and given the circumstances we are of the opinion that this alone has the potential of shaking the markets and creating tidal waves of instability throughout the EU land.

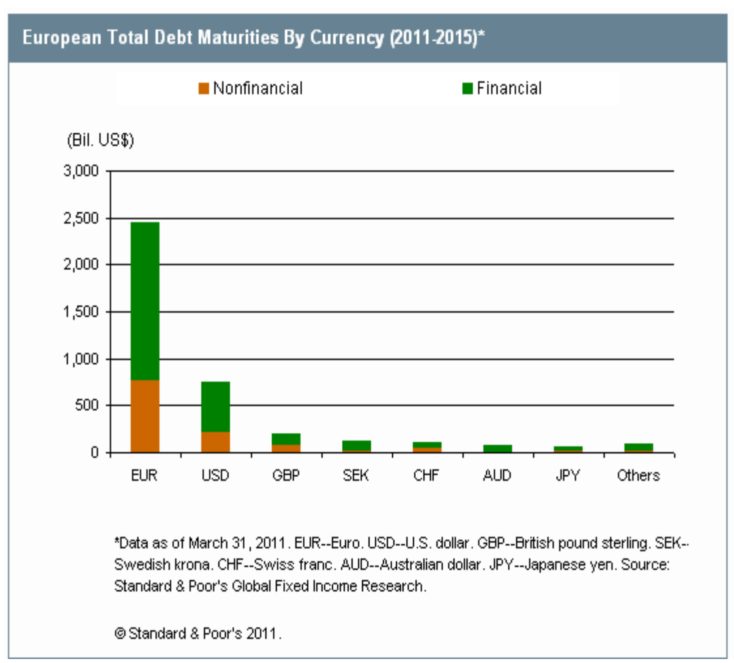


As the following graph shows it is the major countries' financial institutions that will be facing the heat.



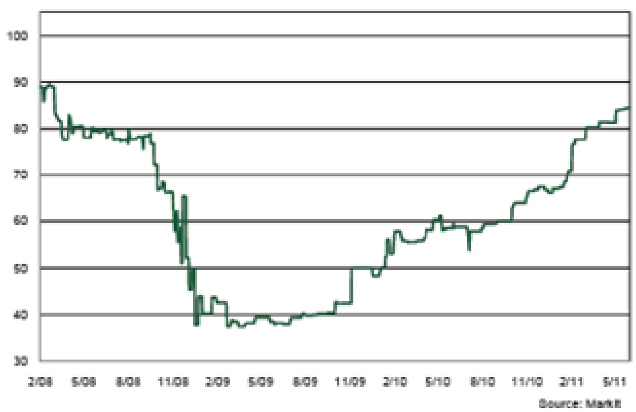


Given that that great majority of this huge debt – under the current circumstances – is in Euros, we also question the Euro's stability in the medium term, if not in the short-term too.

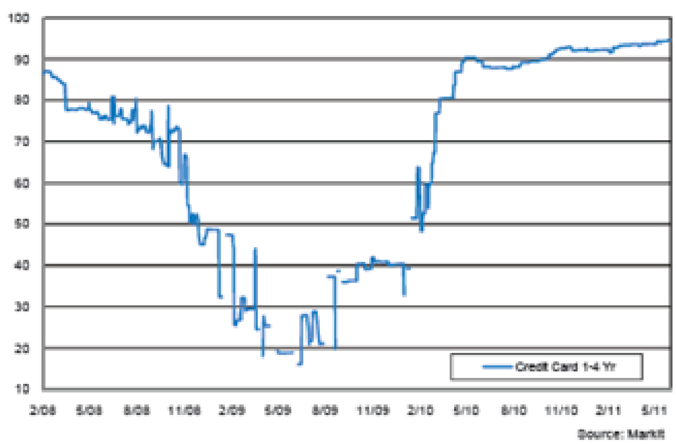


As we wrote in an August commentary, when we see BBB-rated EU paper hitting again the pre-2007 highs (see figures below), we know that market fusion cannot identify real assets needed, and hence the paper assets are destined to collapse creating black holes and a GRB phenomenon that could crash market and real life.

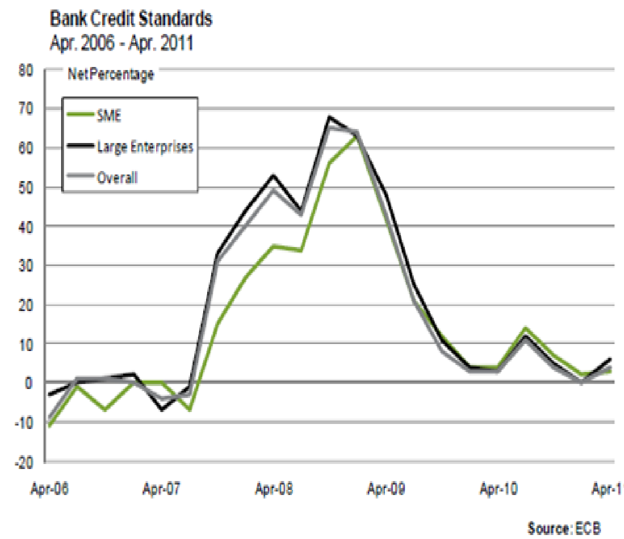
Pan-European 3-5 Years, BBB RMBS Prices

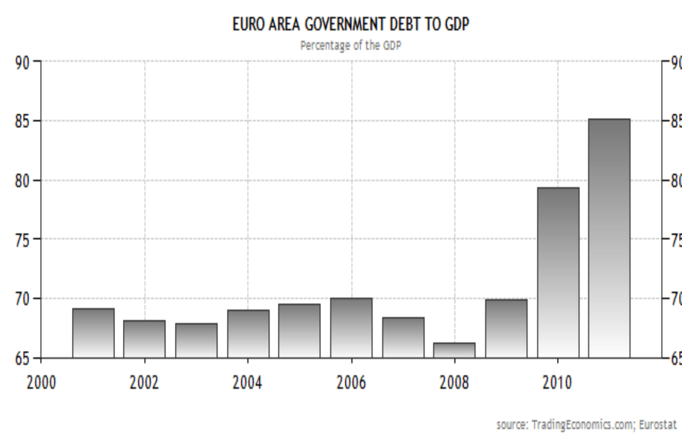


Pan-European 1-4 Years BBB ABS prices

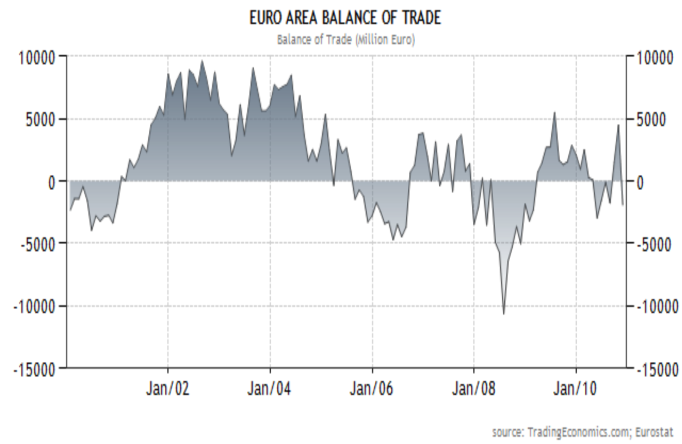


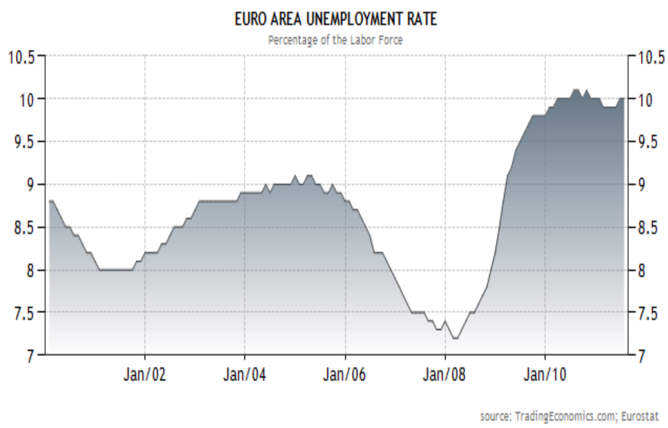
At the same time, we observe that bank credit standards are dropping while financial instruments such as CLOs that significantly contributed to the 2007-'08 crisis are exploding again.

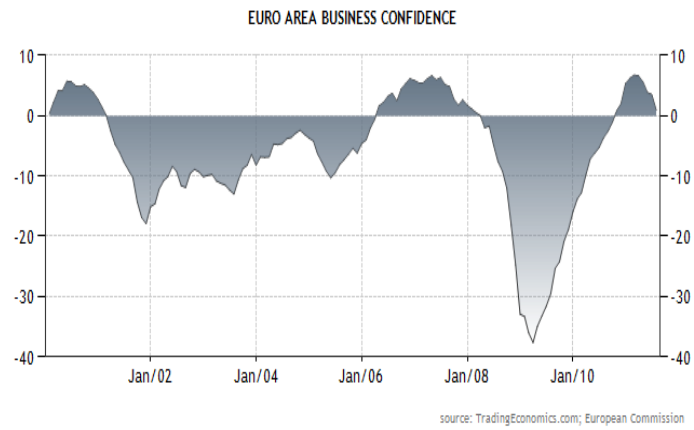


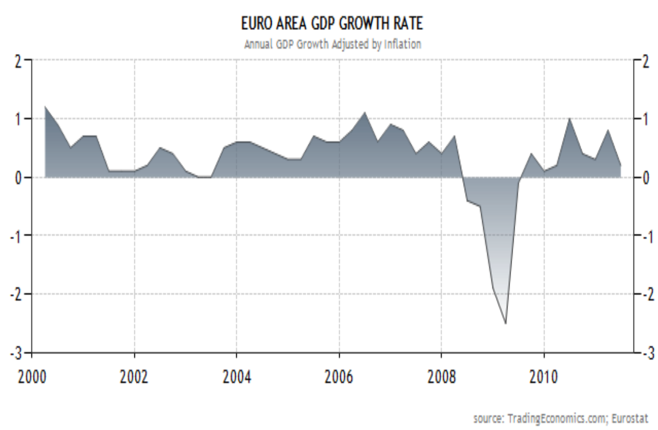


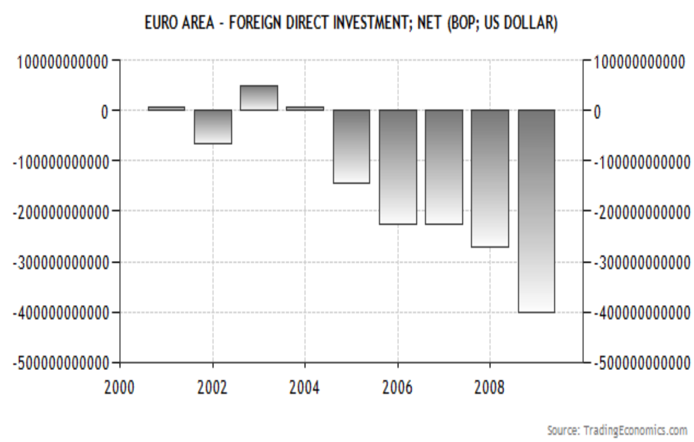
The explosion of debt in the EU was accompanied by an equal explosion of reserves that has been misallocated with the result that unemployment keeps rising, equities markets question the asset-side of the balance sheets, growth is anemic, trade balances are deteriorating, business confidence is dismal, while foreign direct investments are collapsing, as the following graphs demonstrate.









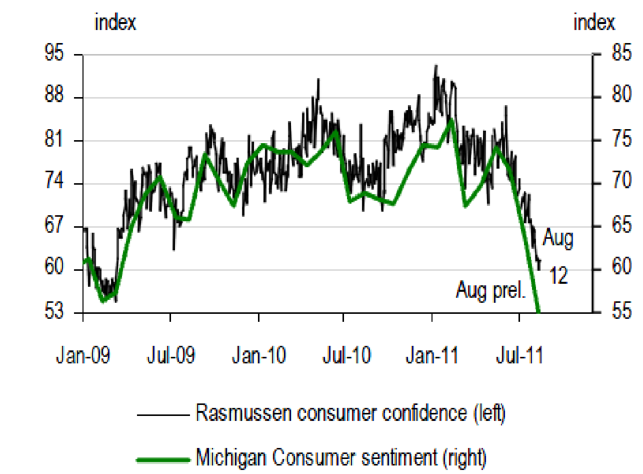


The EU prospects for growth, debt reduction, and lower unemployment are not that encouraging making us question the viability of its currency under the current regime. We are of the opinion that that Euro's strength will be questioned while EU banks will be forced to find partners, hence an M&A activity may temporarily uplift spirits.

U.S. Developments

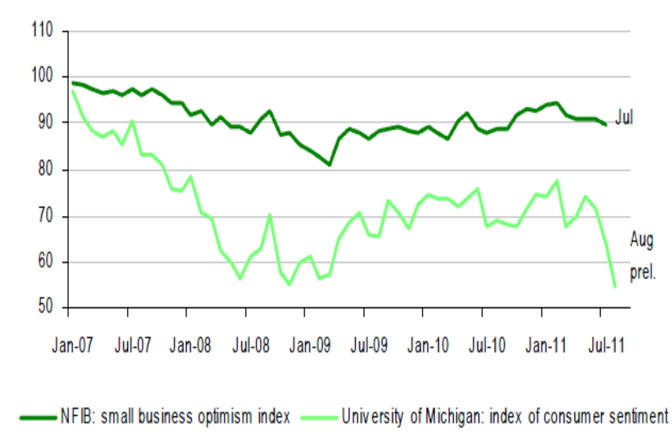
We will start the developments on our side of the Atlantic with the declining business and consumer confidence as the graphs below demonstrate.

Consumer confidence has plunged recently.



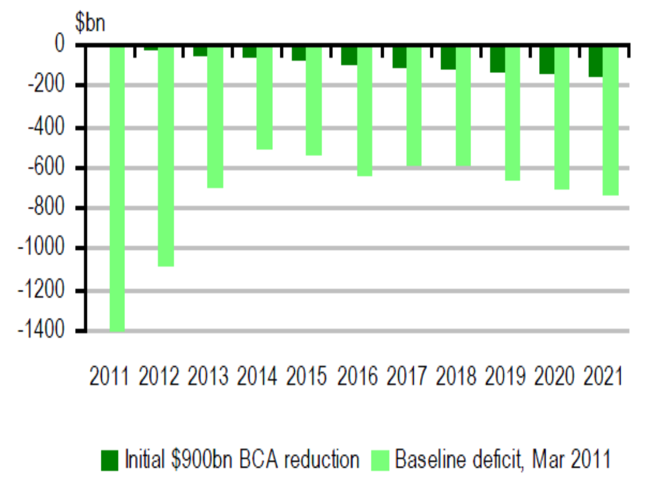
Source: Rasmussen Reports and University of Michigan

Consumer and small business confidence have been retreating.



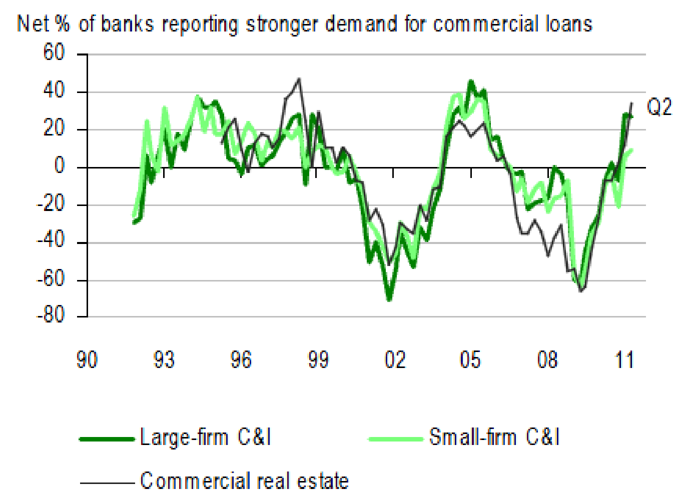
Source: National Federation of Independent Business and University of Michigan

At the same time while deficits and debt are rising, the Budget Control Act (BCA) seems to have dismal effects, as the following graph shows.

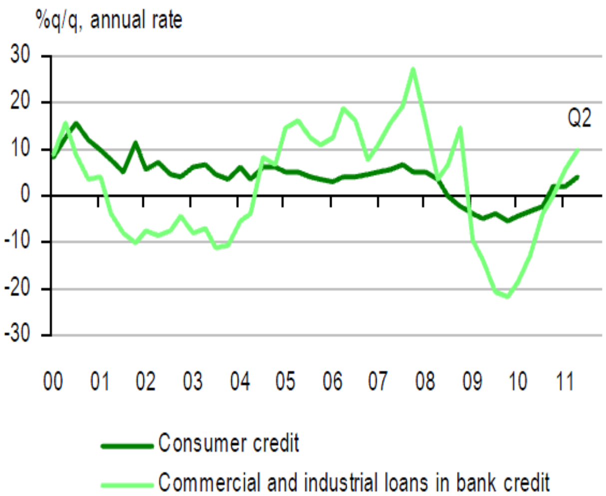


Source: CBO and UBS

Now, consumer credit and bank business loans seem to be picking up which is vital for the money multiplier process and for growth, as the following figure shows.

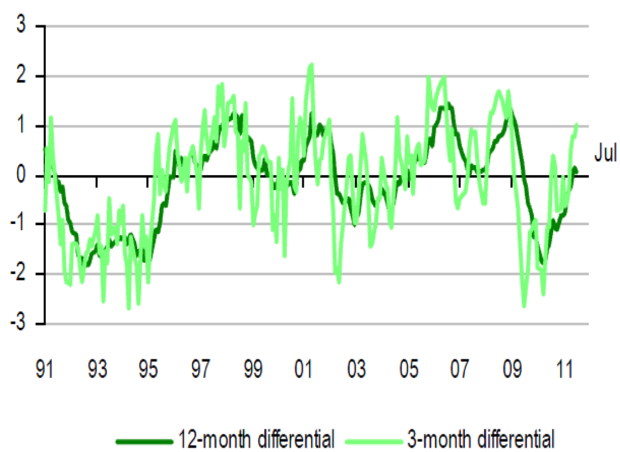


Source: Federal Reserve Board



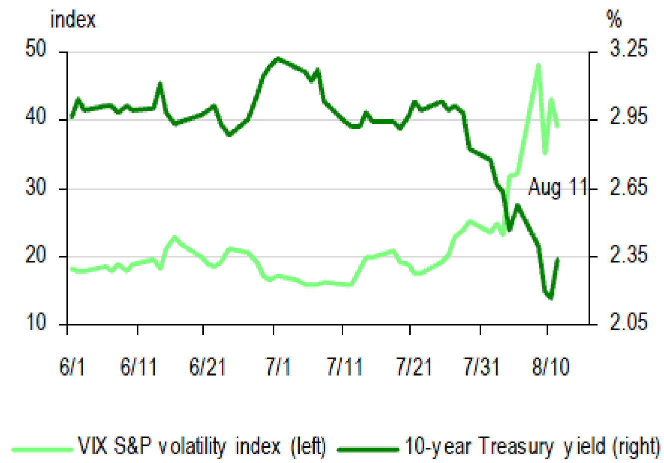
Source: Federal Reserve Board

Some additional good news is that the high-wage job growth minus the low-wage job growth has been showing positive trends which should uplift spending and growth.



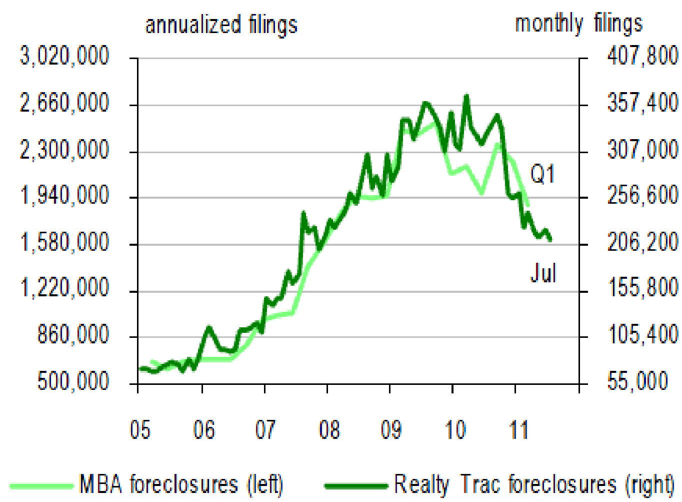
Source: BLS and UBS

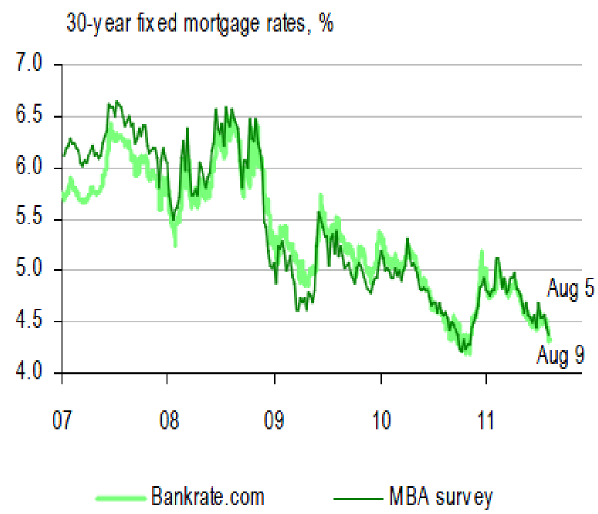
We anticipate that the equity volatility will continue and may even pick up speed in the near future and taking advantage of that might not be such a bad idea.



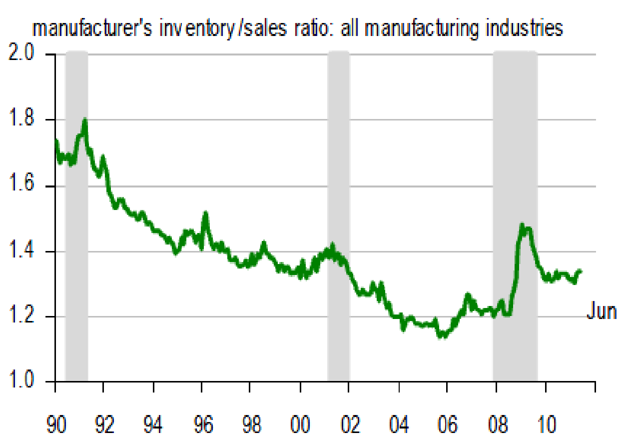
Source: Bloomberg, UBS

Now, the fact that foreclosures are dropping and at the same time mortgage rates are dropping too, may point to an upward trend in real estate in the medium term.

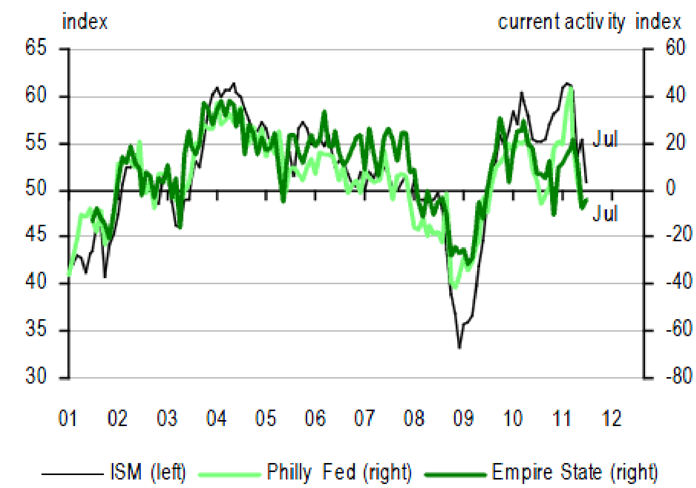




The manufacturing and shipment data are not that encouraging, as the following two graphs demonstrate.

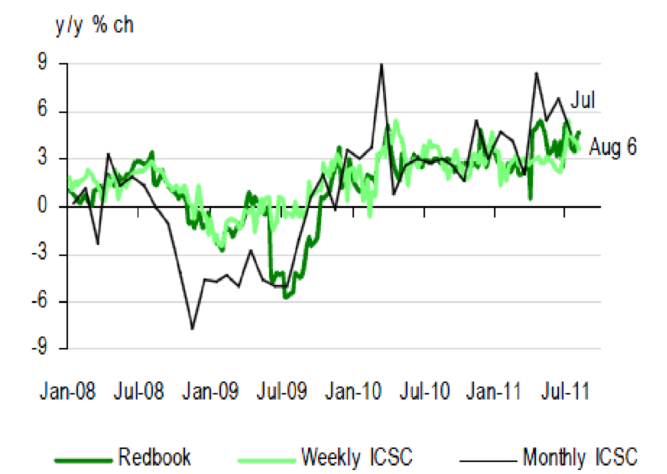


Note: Shaded areas mark recessions.
Source: Census Bureau



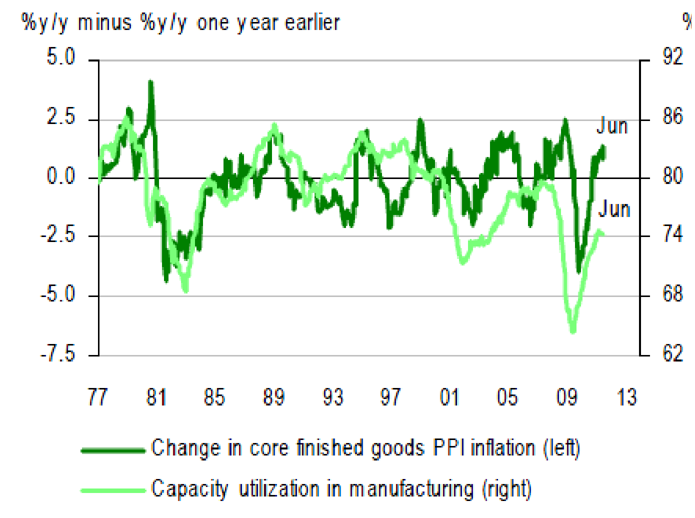
Source: Federal Reserve Banks of New York and Philadelphia and Institute for Supply Management

Now, store sales also demonstrate an uptick which points out - along with the previous data on loans - that employment numbers will improve in the near future.



Source: International Council of Shopping Centers and Instinet

Even more important is the fact that capacity utilization numbers are improving.



Source: Bureau of Labor Statistics and Federal Reserve Board

Where does all this information then leave us?

<u>Conclusion</u>

We believe as we wrote in the introductory section that political and monetary measures will uplift the markets' prospects temporarily. However, the reality of bad fundamentals will awake fears and tremors, and the major EU problems may create financial and economic tsunamis that can shake up the global economy. We are also fearful of potential negative developments in the Middle East that may lead to a heated conflict.

What do we then suggest for the short-term?

We believe that some exposure to good companies that pay decent dividends is a good tactic while loading up in currently cheap and clean energy sources would also be wise, and at the same time strengthening -when opportunities arise - the portfolios with miners and metals.

Ode to catharsis!