

Global Strategy Weekly

We are now walking on the deflationary quicksand

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Global asset allocation

%	Index	Index neutral	SG Weight
Equities	30-80	60	35
Bonds	20-50	35	50
Cash	0-30	5	15

Source: SG Cross Asset Research

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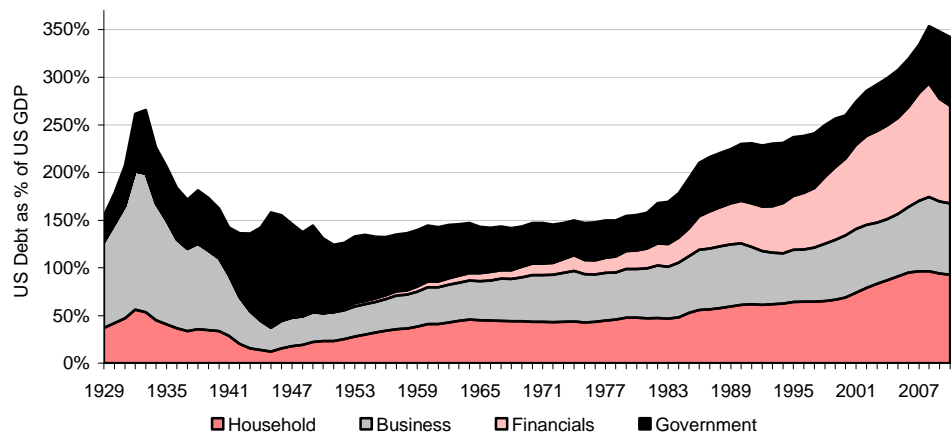
The clowns pulling the levers of fiscal and monetary policy will take us back into recession. But this time outright deflation beckons and we will all be turning Japanese. Yet the fiscal hawks are right to say that the fiscal situation is unsustainable. Our view is that governments are indeed insolvent. But the doves are also right that current tightening will take us back into recession and drive the deficits even higher. There is no 'good' way to end this. Ultimately central banks will be forced to print and print for fear of the alternative. And maybe 20%+ inflation will indeed prove to be the 'best' (or least bad) way out of this mess.

■ Our view that this economic and market recovery will collapse like a pack of cards as soon as the steroid-like stimulus is reduced is gaining ground. Most forward-looking leading indicators now signal some sort of second-half slowdown. The only area of debate now seems to be in its magnitude. By the end of this year, I believe we will be back in recession.

■ At the same time, although our deflationary arguments are gaining some traction in the bond market, investors have yet to fully acknowledge we are now walking on the deflationary quicksand that will inevitably suck us towards total fiscal and financial ruin - you ain't seen nothing yet. With core inflation rates now sub-1% in the eurozone and the US, we are only one recession away from Japanese-style deflation. Recent fiscal tightening will hasten the speed of our descent into this quagmire. The market reaction to the acknowledgement of that fact is likely to be unprecedented in its savagery. The response to the coming deflationary maelstrom will be additional money printing that will make the recent QE seem insignificant. The super-inflationary end result will become obvious to all.

■ Data from the recent Federal Reserve Flow of Funds report give us an update on the progress of the economy-wide de-leveraging in the US (see chart below). These trends are crucial to understanding the deflationary forces that are overwhelming current attempts by impotent policymakers to pull our economies free from the already enveloping quicksand.

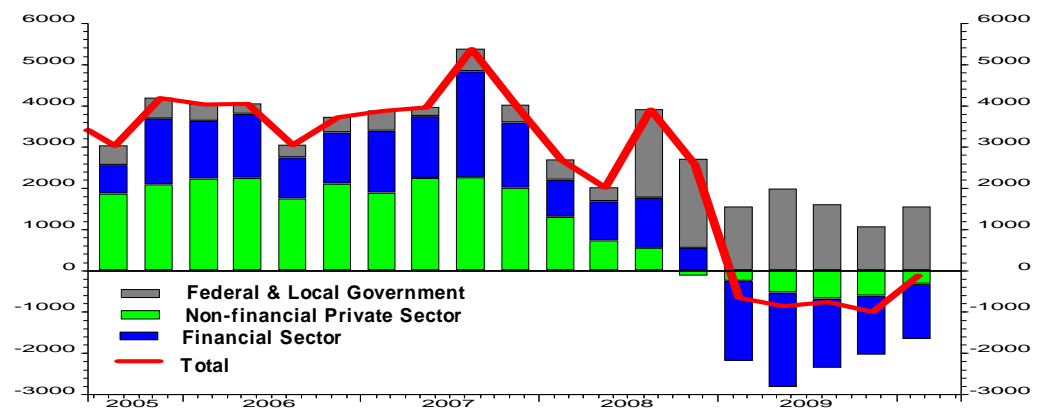
US total domestic debt/GDP composition (as % of GDP), including 2010 Q1 data



Source: Datastream, SG Cross Asset Research

The years of ruinously negligent monetary policy will similarly take years to rectify. Although government insolvency is at the forefront of most investors' concerns, governments have merely taken on the debts of the private sector, allowing a semi-orderly unwind of the private sector excesses (see chart below). This is the same as it always has been. All that is different is the order of magnitude. When all was going well in the mid-noughties, we often wrote on these pages that government deficits in the US and UK would end up in excess of 10% when these 'Ponzi' economies collapsed. In my opinion (and I said this in the so-called 'good' times), Central Bank Governors Greenspan, Bernanke, King and George were all criminally negligent in their monetary laxity while excusing their own incompetent inaction by blaming excess capital flows from Asia.

US credit disappears down the plughole: total borrowing by sector (\$bn annual rate)

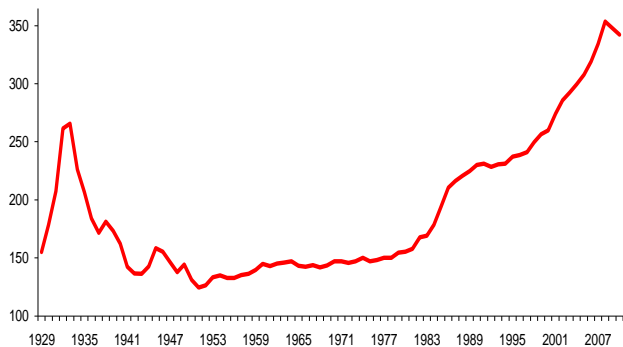


Source: Datastream, SG Cross Asset Research

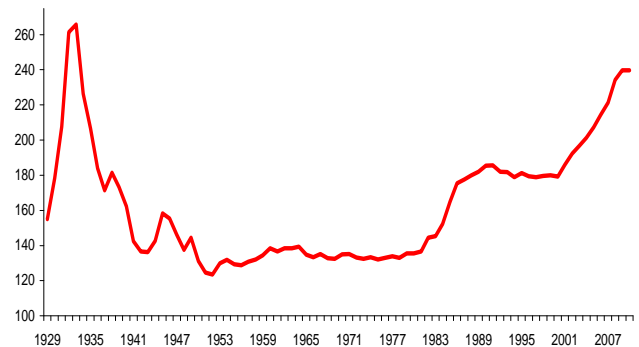
This stinking fiscal mess will ultimately be dumped at the door of the monetary authorities who, unbelievably, are still squatting on their thrones of power. Inflation is always and everywhere a monetary phenomenon, but as Dylan Grice has written, fiscal insolvency is usually the catalyst for monetary debasement. This fiscal mess will indeed end up with the monetary authorities just as it did for the unfortunate German Reichsbank Governor, von Havenstein, in the 1920s.

What is clear so far is that financials have led the way in the de-leveraging process. Some economists far cleverer than I believe that financials should be excluded from these economy-wide debt to GDP charts as there is double counting. Discussions with Dylan and my former colleague James Montier led me to think actually they *should* be included. But we present both (see chart below). Most worrying, this suggests that, excluding financials, no economy de-leveraging has yet occurred. That is yet to come!

US total domestic debt/GDP (as % of GDP)



US non-financial domestic debt/GDP (as % of GDP)

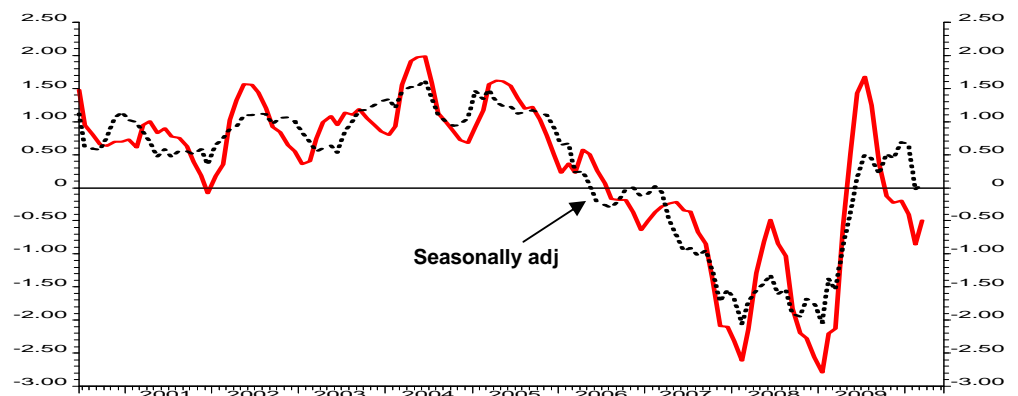


Source: Datastream, SG Cross Asset Research

The latest dreadful housing sales data in the US indicate just how dependent this sector has been on steroids as well for any sort of recovery. Withdraw the stimulus and down comes the house of cards. But even before the latest appalling data it has been clear from the slide in the weekly data on new mortgages for home purchases that there has been no underlying recovery in the critical housing sector.

But just consider – even before the housing incentives ended in April – house prices had been sliding for six months in a row (see chart below)! On that basis a far more discernible slump in prices may be imminent. (Note that the raw data is not seasonally adjusted. Running the series through a Datastream seasonal adjustment programme there is still a discernible slowdown of house price inflation *before* the incentives ended.) A renewal of house price deflation will of course add more volume to the already audible sucking noise of an economy sliding into outright deflation.

S&P/Case-Shiller 20 US cities home price inflation (mom %)

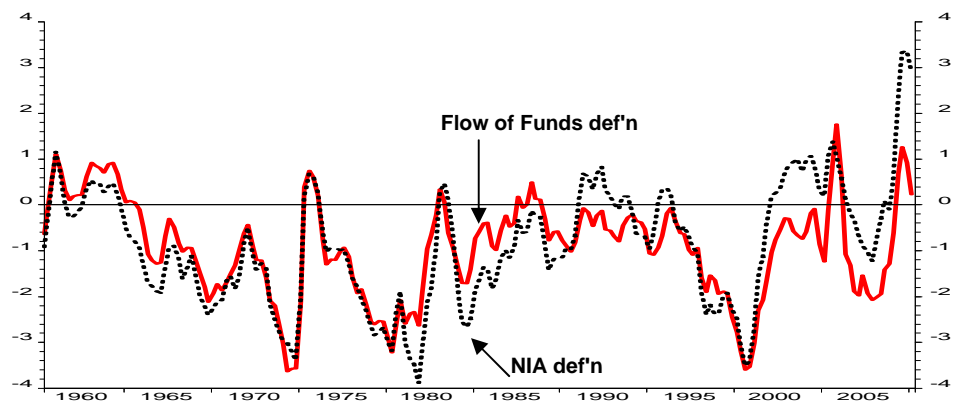


Source: Datastream, SG Cross Asset Research

Finally, a quick thought on the US corporate sector. Many see USA Inc generating huge surplus cash which they conjecture can be spent either to boost capital investment directly, or alternatively to buy other companies' productive capacity via mergers and acquisitions. We looked at this back in January and offered a word of caution. The newly released Federal Reserve Flow of Funds data suggest that on their version of this important measure, no such surplus now exists and to the extent there was one recently, it was due to the inventory

liquidation that has now ended (see chart below). We acknowledge that we are indeed far better placed than when we saw 3%+ deficits, but on the Fed's measure there is no compelling evidence that an investment/M&A boom is imminent.

US corporate sector free cash flow (as % of GDP): Flow of Funds definition shows there may be no huge surplus to spend on M&A and investment



Source: Datastream, SG Cross Asset Research

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