Classical Insights

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Bullet Points January 24, 2014

There is a lot going on out there. The Turkish 5-year CDS spread just broke to its highest level in 18 months. Currencies are weakening in Argentina, Brazil, Ukraine, Russia and Turkey. Clearly, my recent dabbling into busted EMs was premature -- but the signs are not all negative: Perhaps most interestingly, the Shenzhen Index is *up* 6% over the last week. Thoughts:

1) <u>At the core of all this is the drop in gold from $1,900/oz. to $1,200/oz.</u> One can quibble around the edges as to the significance of that move, but a $700 drop is a lot no matter how you slice it.

2) <u>China's December PPI was NEGATIVE 1.4% -- a direct consequence of lower gold combined with a too-strong yuan.</u> The Chinese are digging themselves a deflation – at precisely the wrong time. Given all the loans the Chinese spread around over the past few years it makes no sense for them to increase the real burden of those loans, yet that is exactly what they are doing. Debtors now have to try to repay in currency units that are far more dear in real terms. It's no coincidence that coal companies are the epicenter of the blowups. Stuff you dig straight out of the ground is always the quickest to adjust to a change in the real value of money.

3) <u>Ukraine is cracking too and partly for the same reason.</u> Ukrainian policymakers have mistaken currency stability for strength – but what the fixed hrivnia rate really gave them was deflation, stagnation and now rebellion in the streets. The hrivnia is easing off a little now but it may be too little too late. I've spent a fair amount of time in Kiev and have been emailing people I know there. To a person, they have been out in the streets protesting. The Ukrainians I've met have been among the most pessimistic people I've ever encountered. They hate all their politicians, regardless of the party and just want to GTFO of Ukraine. The country is a true kleptocracy. The recent deal with Russia sparked civil unrest because it seemed to seal the fate of young people. They feel they are doomed to be cannon fodder for the kleptocrats, sentenced to perpetual misery so the rich can control everything. Corruption isn't so bad if it is combined with good governance, but in Ukraine's case it's not. As one guy put it to me, "The corruption became corrupt, and that is our problem. It used to be better organized."

4) <u>The Turkey situation is a little strange.</u> They are on Europe's doorstep so there's no overt necessity for it to crack up. Exports actually may evolve quite well. Valuations aren't overly exciting though.

5) <u>Last night and this morning I modeled out 10 Indonesian industrials that seemed potentially attractive -- and didn't see anything I wanted to get involved with.</u> Everything was messy. A truly attractive market will tend to just sort of fall in your lap: The valuations will be *obviously* cheap and the companies will be easy to model. That's not the case right now in Indonesia. Doesn't mean it won't work. It's just not easy to figure out right now.

6) <u>The official Argentine exchange rate has weakened to 8/US$ and the blue rate (street rate) has fallen to 13.3/US$.</u> Three weeks ago, I was getting 9.6/ US$ on Florida Street in Buenos Aires. Obviously, fiscal policy is anti-growth, *but the strong dollar is making it worse*. US wheat has fallen from $9/bushel to $5.85 over the past 18 months. In theory, Argentina's own currency weakness should offset this, but entrepreneurs' hands are tied so tightly in Argentina that currency weakness may not be helping as it should. If/when a corner is turned, Banco Frances ADRs are the way to go. The banks are making lots of money from the devaluation/inflation combination: They are being flooded with zero-cost checking deposits (people don't want to buy fixed-term CDs) and lend them out at ever-

higher rates. This works great in a controlled decline, but in a complete currency collapse all bets are off. Hard to say how this will evolve.

7) Is the Fed taper a mistake – and is it driving this correction? There are two schools of thought here. One is that the Fed is just draining out excess cash that nobody really needs anyway (because demand for safe assets has declined). The other school is that QE works by floating up asset prices and driving capital flows to riskier, growthier portions of the US (and global) economy. So, the thinking goes, *if you get rid of QE the risk-on portion of the economy will starve and crash, just like 1937*. Bears worry that Janet Yellen does not understand how QE really works, and thus fear she will stand idly by as some sort of conflagration besets the emerging markets and only belatedly the US. This would essentially be a repeat of the 1997-2002 scenario, in which Alan Greenspan stood by while gold fell from $370/oz. to $250, causing crash after crash in emerging markets and commodities.

8) In theory, at least, Japan should be able to sail through all but the most extreme exogenous problems thanks to its massive QE program. The BoJ has stated more than once that it is committed to printing as much as necessary to hit its growth and inflation targets. QE is right on track and the monetary base is exploding. December corporate results should be fabulous, with plenty of guidance increases to go along.

9) Ironically, gold is starting to rise again. Not sure what to make of that, if anything. More thought is needed. Could be something interesting here.

10) Investors have been flocking to Pakistan because of its *weak* currency history, strong grass-roots growth and the absence of any bubble overhang type of problem. In a de facto deflation, *currency weakness is the right policy*.

11) Some emerging markets aren't doing much. Polish CDS spreads are actually improving. Sri Lankan stocks are going up a bit. Clearly the epicenter of this decline lies with the markets most sensitive to capital flows, commodities and/or China growth. Poland is more adhered to the fortunes of Western Europe now and thus trades more like a developed market.

12) Murray Rothbard would have fun with the China situation. He would say they have two choices: print or crash – and the right choice is to print. At the moment the Chinese are doing neither. But pretty soon they may be forced to get more pro-active. So far, the Chinese have been able to rely on various shadowy vehicles to create and/or absorb all the supposed "debt" that is being created (which is really just spending). As these start to go bust the cat will be out of the bag: Everyone will recognize that much of this stuff is mis-classified as debt and is better considered to be spending. China can solve a lot of these problems by printing more money and/or devaluing. I'm surprised that yuan futures keep strengthening. They are closing in on 6/US$. Seems like a policy error on China's part.

13) The Shenzhen Index has been going UP and most HK-listed banks remain in a long-term trading range. So it's not as if all Chinese data points are bearish. The Shenzhen Index is up 18% over the last 6-7 months and 6% just in the last week. This wouldn't be happening if China was a basket case with no way out. Clearly the Chinese have more cards they can play. The most obvious is to ease the currency/credit situation.

14) Regarding Brazil, one concern with the utilities is that some will get caught in a margin squeeze as costs go up (due to currency decline) while regulators prove slow to give price hikes. That's what has destroyed the Argentine utilities. Dilma is a Cristina-caliber lefty so she will have no qualms shafting the utilities if it suits her aims.

The Classical Insights portfolio holds Banco Frances (BFR US).

Mike Churchill

Churchill Research, Inc.
103 W. Broad St., Suite 220
Falls Church, VA
22046
(703) 241-0274
(703) 340-4726
mike@churchillresearch.com
www.churchillresearch.com