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Cheap Money, Expensive Love, and The Bundesbank

The Bundesbank recently announced they were willing to accept a 'little bit' of inflation...

The main Chinese banks stopped lending for two weeks in April while M1 growth went negative....

Combined, these represent a sea shift in policy that over time changes the balance of trade flows as well as asset prices.

First Germany: Finding out that the Bundesbank is amenable to a little bit of inflation is about the same shock value as finding out one's mistress is a little bit pregnant; even if one's last name is Pinault, CEO of the French conglomerate PPR, and the lawsuit is by one Ms. Evangelista, no introduction required. The German press has taken to the whiff of inflation about as kindly as one's wife would to a paternity suit. However, as Salma, the current Mrs. Pinault, will find out, good multi-billionaires are hard to find, and the German public will realize eventually, so too are good central bankers. Given the implosion of Greece and the desire to prevent Europe from regressing to early 20th century politics, they will forgive the Bundesbank 3-4% inflation. Unfortunately, the 'little bit' part applies to inflation the same way as it does to pregnancy. Pick your poison: mild deflation or rampant inflation.

In China, Bo Xilai's departure implied a resolution to a struggle for the future of China's economic system, where Bo was promoting a proletariat's inflationary revolution that would wipe out the savings of the urban bourgeois in favor of welfare checks or debt forgiveness for his favorite constituencies (read: rural real estate speculators now under water). One can see parallels in the political / central bank nexus of the US, where Comrade Chairman Bernanke and General Secretary Obama are trying to achieve about the same thing. In the event, Bo lost, and the flimsy excuse used to discredit him, of the death of a British broker having likely been instigated by his wife, where he is possibly responsible for hundreds of extra-legal incidents of violent expropriation, was somewhat amusing. Mr. Bo would like us to believe that he has been framed by criminals, as he plays to the Communist Party's image of political harmony, hoping to resurrect his career, and states he should have divorced his wife anyway. His logically inconsistent stance, revealed through the Japanese press, no less, simply fails to hold water. He might get acquitted of his wife's actions, but a swift rehabilitation of his policies is unlikely.

The result is that as Europe will attempt to inflate its way out of a recession, China will find itself in one. It would be hard for western central banks succeed enough, or quickly enough, to offset the impact of China's decision to allow markets to clear, so assets may head towards a structural bottom in the next 9 to 18 months in the US and 'core' Europe, and in China, India, and energy + materials exporting countries who are their primary vendors. For Russia, Brazil, Australia and Saudi Arabia, the impact of Chinese (and Indian) demand for commodities has been roughly equivalent to that of the dotcom boom on California. This mercantilist ecosystem also impacted the derivative of these countries' economies, i.e. the price of residential apartments in London, Singapore, Hong Kong, New York, and Miami Beach, which serve as stores of wealth for their elite. You can probably traffic a human being from the poorer parts of India at the same price as a square foot of the *Shard*, the latest residential tower in London. Something has to give.

I began writing this note sitting in Mumbai, India, where most people still ignored the possibility of real estate becoming distressed. Before the latest macro numbers, the financial crisis was a temporary, distant blip; asset decline was arrested quickly by a printing press, but now that has led to persistent 7% inflation and a currency that has suddenly taken water. I would repeat a rule of thumb I credit to Mr. Barton Biggs in an interview given long ago: the asset falls by 40% and the currency falls by 40%, and then you search for bottom. But then he assumed good fiscal policy, which India aspires to. Even now, the Rupee might have a little bit left to go, and apartment prices, well, a little bit more. As for London/Sing/NYC, at $6k/ft, the supply is infinite. Many retirees holding up rent controlled apartments from demolition will not wake up because someone pulled the plug on their respirator in the night; cars will be crushed by construction accidents above the parking lots of owners refusing to sell, etc. etc. but at these prices anyone who is willing, can find class A apartments with central park or river views, even in Bernanke dollars.

The Battle of Spain

It seems the battleground for the defense of the Euro is going to be Spain, and the Spanish government realizes as much. History chooses people, and if one had to guess why Italian spreads are tighter, one would suggest Mario Monti's presence. He has the credibility in Brussels and Berlin to be afforded breathing time; I would daresay Herr Schäuble, Germany's finance minister, actually *likes* him, if he maybe be accused of such a sentiment. The Italian budget is already in a primary surplus, and its beaches were not the focus of speculative development to the degree Spanish ones were, so banking balance sheets are less suspect. While unions will resist and Italy may yet get bailed out, capitalism has crossed the Rubicon, literally.

The sovereign debt problem is hardly unique to Europe, so the crisis is really about the efficiency of banking and labor markets. This was an unnecessary objective in the days where everyone periodically devalued vs. the USD and DEM (Deutschemarks, remember those?), and inflation cured many politically motivated lending decisions. So Europe acquired a hard currency without the corollary constraints. The question being asked is, can a society renegotiate fast enough? If this was solely about sovereigns, the biggest worry would be France (and we may yet get there.) But for the moment, the question is: Can this particular financial system + labor market restructure without default? In that sense the Spanish banks, often influenced by regional governments, are held with suspicion. (I am not passing judgment -

the Greenspan and Bernanke Fed, with all its presumed wisdom and independence, did little better - merely speculating on the reasons for bond prices.)

Sir John Templeton famously stated about bottom fishing in speculative real estate (priced a hard currency) - 'Take the highest price paid, divide by 10, and start bidding.' By that estimate, assuming that the Euro remains a hard currency, all Spanish banks are toast. There is also a second problem. Spanish mortgages are recourse loans. 80% of Spaniards owned homes at the peak of the market. If 60% of them still have mortgage balances, then half the country is under water from loans it cannot walk away from. The typical collateral value in default as of now is 60 cents. For it to not to head to 20, the Euro must soften, else I seriously doubt Spanish society will survive within the current European framework.

Spanish banks will, through legislative change or in practice, allow people to walk away from mortgage loans. Still, given the sheer size of the popular participation in real estate speculation, the scar on their society will match the expense of the Anglo-Spanish War (1585 - 1604). But it doesn't end here: most of the mortgage backed securities are parked with the ECB as collateral, and well, in the ECB's systems, the Bundesbank is a $1 trillion creditor. The Germans now own a meaningful percentage of Spanish GDP....

Hence the choice for Germany becomes clearer: Allow the Euro to devalue by 40%, and refinance the banking system of Europe. Or, it is highly likely that the EU fragments politically. The southern countries will be forced to leave the Euro and go bankrupt, and Germany will face Euro 1 trillion in credit losses through the ECB's lending of money not designed to come back, and another trillion through direct public and private lending. The antagonism would be politically catastrophic. One can now assign a 5% probability to a complete political realignment of Europe, where an alliance of Russia and Germany holds an adversarial position vs. southern Europe. Yes, this is unthinkable and ridiculous, but then the Greeks thought they were AAA.

The is dawning on the collective German political consciousness a little bit at a time, thanks in no small part to Chancellor Merkel, who has done a remarkable job educating her electorate while handling the pressures of the outside world. Having talked to some German portfolio managers, I do not believe the will to save Greece exists. But after that, they are resigned to doing what they have to for the rest of Europe. Or so one would like to hope. I believe a necessary condition from the German point of view is for southern European political leaders to hold up a mirror to their electorate when asked to assign responsibility for their predicament, and achieve a political consensus, which only Ireland seems to have, to accept it as the consequence of their collective choices....

From Rational Investing's point of view, the miracle in all this is that our valuation model actually held up over the past year, and if anything the Sharpe Ratio has been improving slightly. Not to mention that, in a mildly deflationary environment, market neutral equities would likely outperform other asset classes. If you are looking for a process to allocate equity risk to, I would humbly suggest you continue to read the following charts and paragraphs.