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Orange may not be The New Black, but China is the New Greece

A couple of years ago, Mr. Hugh Hendry, a London based hedge fund manager, was reputedly banned from China, or at least his Youtube uploads were, for documenting newly built yet empty third tier cities. While someone living on Third Avenue in Manhattan would have reason to be jealous of the lack of traffic recorded, the point remained that an economy spending 50% of GDP on building empty towers and unaffordable bullet trains was headed for trouble.

Now, the New York Times is predicting a hard landing. When the left leaning press begins to identify problems of government design, it is usually looking in the rear view mirror. The real trouble is that government planning has a perfect record of bankruptcy. No state has survived socialism disguised as bureaucracy to pay off its debts. Yes, China's government owns USD 3 trillion of Treasury's. However, that is gross of 750bn of sovereign debt, and is completely overshadowed by $20 trillion owed by the banking system and lent to municipalities and state enterprises. And, as the bondholders of Ireland, Spain et al. found out, banking debt is not sovereign debt, until a meltdown begins. I would question if the queues outside Chinese banks will be as peaceful as those in Cyprus. Muni debt alone approaches $2trillion before Special Purpose Vehicles are counted, which caused a little hiccup in the US in 2008.

So a country burning a trillion or two a year on projects that would trade at 30 cents on the dollar is unlikely to be able to pay the debts associated with said projects, some of which, one suspects, would make Goldman's Abacus bonds look good. People worrying about Spain are focused on the wrong continent, and the wrong order of magnitude of problem. Finally, imagine a buy order for $3tn of Yuan: It would instantly bankrupt every exporter in China, in case there are any solvent ones left.

In the meantime, the Indian government makes no such pretenses to infrastructure improvement. It would rather just buy votes under various programs called 'loan festivals' for farmers and 'food security' for the poor. Given its lack of presence in world trade outside of software outsourcing, overinvestment by car companies, and weapons procurement, few people outside India particularly care how badly the country is mismanaged; but sitting in Bombay, one struggles to understand how a government where the prime minister studied economics at Oxbridge and the finance minister at Harvard could skew the economy to this degree. Or maybe the degradation of Keynesian thinking learnt at these institutions is the problem. The real catalyst of the current meltdown of the Rupee in currency markets is not the tapering announced by Bernanke, but the decline in the Yen ordered by Abe san, more on which below. Since the Japanese have just started trashing their currency, one wonders how far this goes.

Meantime, in Tokyo….

Quick, Getafix, hand me the magic potion, the Romans are coming…. For those whose childhood was so deprived as to be uninitiated in Asterix's adventures, I would suggest buying the entire stack for your next vacation. The drug dealers, er, druids of the markets, also known as central bankers, are out of magic potion, also known as QE. The Bank of Japan created a tremendous last blast, and the Romans, i.e. shorts, took it on the chin, staging their worst year since 1999. But unlike the comics, taking steroids has side effects in real life. No, I am not talking about the shrinkage of certain body parts and other teenage locker room stories. I am talking about currency wars. One has clearly started. If a 30+% drop in the Yen in a matter of months isn't a war, then I certainly do not know what is. This is compounding Asia's competitive issues even as QE kills growth. Couldn't they have just invaded North Korea instead?

With the benefit of hindsight, most human decisions regarding money range from the merely delusional, with one's own, to the criminally deranged when it belongs to tax payers. Central banks have printed so much money that they have pushed the price of many assets back to 2007, and, adjusted for the present lack of growth, possibly to 1999 levels. Is this a merely delusional idea that if we all follow Zimbabwe in printing money somehow we will not end up banana republics, just because our dear leaders have Princeton degrees? Or are our bureaucrats engaged in a criminal transfer of wealth that rivals the Soviet attempt to improve the lives of all comrades equally? The Bolsheviks had the cruelty of Russian aristocracy towards the serfs to point to, and it was no mean argument. What exactly is the justification in a society where the government will often spend >100k USD a year on a poor family and the richest are signing pledges to give away half their wealth? The central banks have damaged the relationship between financial and real markets significantly, and destroyed the symmetry of the market making process i.e. the dealers only know how to be long. They might just all sell at the same time….

Yes, there are bubbles everywhere, again. But the question begs itself, what is it that the Fed is trying to achieve? 2000 – 2006, it was growth: the dot com boom ended and per comrade Krugman's advice, credit was supplied until it created a bubble in the dominant asset class: real estate. This time, the goal is to create a bubble in inflation. At this point, some of you will start wondering about this author's delusions. To wit, what central banks are really fighting is the inability of societies to make 'internal adjustments' quickly enough to support nominal GDP growth as defined by bureaucrats, who include government output in such measures independently of private output, which in the long term is irrational. One can sustain a very lightly governed society a la Hong Kong, but sustaining a heavily governed society is another matter altogether. In theory, internal adjustment = a cut in wages. In practice, regulations that empower bureaucrats instead of markets need to be shed, possibly including but not limited to take home wages, but that is at best a minority of the problem. The clearest example is the bickering over shale fracking and oil sands. Even at Euro 100 / barrel, governments are unwilling to part with sufficient property rights to encourage fracking of tight oil, or even permit its production or transport. In the meantime, working at McDonalds in North Dakota shale boomtowns pays $18 an hour.

The Time Lag Between Revolutions

China's wage increases are not sufficient to make Italian or Spanish manufacturing competitive under current tax and regulatory regimes. So? Well, this intuitively leads to demand driven deflation. To boot, thanks to technological innovation there is already and always supply driven deflation. If you throw in income declines, the headline number might just go negative. The BoJ has advised the developed world 'Do not let that happen.' Hence the Fed has explicitly mentioned stock prices as a positive effect of QE, rather than, say the supply of credit to small business. They did not want to state 'well, gold is up' or 'oil is up so there is inflation, phew' and mop their brows on CNBC. The harm here is to the marginal worker, who would be thrilled with half of North Dakota's wages. Money that could be used for maintenance of productive assets i.e. would go into the real economy, is used to buy current stock at low yields from an over-levered if not bankrupt seller. Far better to absorb the seller's loss now than to create a new disequilibrium in asset prices which will take years to unwind.

This is why the gold market's signal is important (to be clear, not to be confused with any long term predictions). Last time, the crack came in short term credit which the Fed had allowed to be pumped up. This time, they are simply looking for higher asset prices to drive consumer inflation, or at least limit the required internal adjustment, paradoxically the opposite of what their policies are likely to achieve. Gold's signal is: There is no inflation. Central banks have failed. The only place where they succeeded was in China, the one place they weren't trying, but the substitution is often for Bangladesh and Vietnam. No one moves shoe factories back to France. Unless the EU reforms, a hard currency will become impossible to sustain. Right now, Chinese bureaucrats are buying the Euro to diversify from USD. If they knew how to buy low, they would legitimately earn Mr. Hendry's paycheck.

Unless central banks really manage to use helicopters to drop cash on the streets, the current widening in Treasury yields will not last. The BoJ's new magic potion isn't able to hide decades of the Diet's refusal to restructure Japan. Or consider Europe's 39 pages of instructions on imported bananas as exhibit A or America's refusal to allow oil pipelines from Canadian tar sands to reach Texas, as if they were bombing women and children on their paths. The side effect of holding up Keystone XL is that the Canadians will, for the first time, export crude from North America. Congratulations, Mr. President. Meanwhile, even as energy prices in the Americas have fallen from shale supply, Brent has held up thanks to regulatory intransigence against tight oil in the face of 25%+ youth unemployment, not to mention Germany's delusion about shutting down all its nuclear plants. One wonders why there is so much time lag between revolutions. Maybe Europeans should learn a lesson or two from the Egyptians.

The Pornography of Big Government….

Messrs. Carmen Reinhart and Ken Rogoff are stating the obvious that high levels of debt are correlated with low growth. The problem isn't the actual debt however, or some spreadsheet bug. Every NASA rocket launches with >10k known bugs. We still have satellites for cellular chat lines for tweens and for real time pornography for adults, which apparently occupies >10%

of trans-Atlantic internet traffic. The problem is government porn – the idea that more bureaucrats are better everywhere, always. Italy has no growth, yet its customs held up the import of my partner's business cards from India. A single pack. They wanted a certificate that they were worth <$20. I didn't know my 18 person firm could afford gold plating necessary to make them worth more. Usually, it is the other way around i.e. people are trying to smuggle gold into India. One fears Italian civilization peaked the day Julius crossed the Rubicon….

So yes, government has to spend less. Ireland with low corporate taxes, is leading out of Europe's crisis. But much more to the point, the solution to slow global growth is not merely fiscal. Government porn needs to end. Until Italians let more than business cards through unchecked, and the Japanese, say, allow foreigners, not to mention women, to fully participate in their economy, the world will drift along. In the meantime, Central Park and Knightsbridge real estate makes Pets.com look good, and not to mention back country Greenwich – heading to tear down territory in its own genteel way, where, when a house only remains fit for Bruce Willis to blow up in a movie scene, they call it 'downsizing'.

And what of the equity market? http://www.rationalinvesting.com/ETFModels.asp - Our Market to Model ratio for the S&P500 is near 1.15, a level last seen in the good old days of 2007, when the repo market had the first hiccup. Now India's Rupee has cracked and one wonders which domino is next.

The one piece of good news is that Iranians have run out of options, and any negotiation with them will release oil supply. Mexico has also amended its constitution to incentivize oil firms. This could help mitigate the next down cycle for the economy. Any bounce from the Syrian crisis is worth selling into. Still, oil will remain unnecessarily expensive until, faced with interminable double digit unemployment, they start digging off the coast of California again. Meantime, we choose to keep in the dark ages large parts of the human population due to the sanctimony of those who can buy Papal indulgences, er, carbon credits, for their use of private jets. One could expect some near term violence in the equity market as all this plays out. In the meantime, maybe Tesla should buy GM to top AOL / Time Warner….