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The Fed's Bollywood Romance

The Fed's Exit Strategy is to markets what a Bollywood Romance is to an Indian rural twenty something - plausible, but unlikely in their tenure of youth. There's a lot of song and dance in Swiss valleys and Dutch tulip fields, but the kisses and wardrobe malfunctions, on or off screen, are off limits. In real life the audience's marital fate is set by the network of the community they are born into. I'm afraid Bernanke & Co. are in the same boat. There is a lot of planning for reverse repos, interest on reserves, and other macro techno babble that makes my head spin, not to mention the normal English or engineering major reading the newspaper. But in the end, the economy is not going to oblige. As fiscal support is shrunk in US states and Europe, growth will not rise above trend sufficiently to restore either inflation or jobs in the short term. Government spending cuts are needed across the western world, and quickly, to erase deficits. Contrary to the economics orthodoxy, which is ignoring the issues that arise with debt traps, sharp cuts are necessary. A delay can start a fatal chain reaction that ends with Treasury default. The reduction in government spending will, within a short horizon, wipe out the leverage driven inefficiencies that have built up across the globe, but the process itself will be gut-wrenching. It is also now largely out of the control of bureaucrats. Electorates in France / Germany / US are in no mood for another round of bailouts, even of their own institutions, much less their neighbors'.

Hence, there will be no selling off the trillion or so of Treasury and MBS by the Fed, no raising of rates to equilibrium in 2010. The inventory will be allowed to mature over a decade. As much as long term rates could go down over time as we return to the historical norm of mild deflation, the Fed will not add to any volatility. The Treasury too, is guaranteeing a trillion of implied agency losses on housing debt that will take over a decade to recover. In the meantime, Fed Funds will be 'accommodative' for years. As Greece's troubles prove contagious, and a European rescue package seems imminent, the ECB will meet the Fed at 50 bps. Any rate increase in the US would be marketing to a Congress leaning right of center. The first check the Fed wrote to save Bear Stearns did not end US banking problems, and the first check written to help Greece will not end Europe's sovereign risk. As the optimistic projections do not pan out because the Joneses are saving rather than buying the latest Cadillac, the Fed might start buying securities again, whenever Congress is not looking. Say, by Christmas?

When does the equity market figure all this out? It has been turbo charged by cost cuts and forecasts of supply chain revival. A lot of US assets are trading at values only justified by 2012 margins projected by the sell side. An egregious example is timberland. Who seriously expects housing and paper to rebound quickly? But this has obviously started running out of steam. As we maintain, the US investor has no experience with a deflationary distressed yield curve and both valuation models and intuitive thinking are again overpricing stocks based on cheap money. The clearest trigger for a reversal of valuations would be a shrinkage of corporate margins when growth remains below the pace of balance sheet, and presumably capacity, expansion ongoing in the Far East, the beginning of our supply chain. An indicator of the imbalance is the mismatch between the volume of Chinese imports of Dr. Copper and their lower rate of its consumption. A strengthening of the dollar would take the pegged Yuan up with it and rupture this situation by slowing sales growth and leading to unwind of inventories.

The Mercantile War with China

The Far East, led by China's policies, is continuing to print money to support exporters, leading to high capex rates in a world of surplus capacity, and speculation in their commodity inputs. Worse, the Chinese are supporting the emergence of markets in stolen intellectual property. Western IP is expropriated without shame or censure where corporate defenses are penetrated, or firms are first lax enough to let it happen, then too embarrassed to disclose it. The idea that a highly organized team of hackers sophisticated enough to break into Google's servers can operate in China without the explicit approval of the People's Liberation Army is whimsical.

Meanwhile in Congress, this election cycle will end the careers of many Cold War politicians. The Great Society, built to counter communism and keep the Euro Left in our camp, has peaked. Dealing with China is a very different game from dealing with the USSR. This is not a Cold War, it is a Mercantilist War, sort of the competition between European powers during the age of colonization in the seventeenth century. Our parents, as JFK exhorted, have paid every price, and borne every burden, to see the fall of the Berlin Wall. Ours is now an age of harnessing technology and supply chains for economic uplift, rather than a struggle for values while pointing missiles at each other. The challenge is not any smaller, but the political class is not used to focusing on it.

In the US, domestic agendas are typically managed by the states, and the concentration of spending in Washington is not how this society was designed to function. Congress misinterpreted the last election as a return to the era of LBJ, and got all wrapped up in health care, while unemployment climbs and growth consists of government jobs. That just doesn't work this side of the pond. This, while continuing the adjustment of adding 200+ mm Chinese workers into our trading system? To state the increasingly obvious, the mid-terms will lead to en masse retirements, some more voluntary than others.

Congress, now that the average citizen's disgust with economic mismanagement is crystal clear, will be forced to focus on deficits and competitiveness, reversing regulatory and tax burdens on job creation. That would be a huge positive. But this is not a simple process, and equities are not pricing in the sort of contention about to emerge between NATO and China. India, the other potential 100+ mm workforce at the gates of the global trading system, thankfully has a far more inward / defensive than offensive outlook, else Obama would be signing Smoot Hawley II about now. This is partly because of a Gandhian mindset, whereby urbanization is not by government design, and partly because corporate lobbying is more focused on internal market share than on export subsidy. Their early success in helping the US solve the Y2K problem also created a focus on services, which require abidance, by and large, with the intellectual property framework of the west. Certainly no elected government in India would survive ordering or even condoning a systematic attack against the global internet infrastructure.

As deflation takes hold, oil will be back at $40, the likes of Iran will simply run out of cash to support their own subsidies, much less regional conflicts, and the US government focus will shift to electronic security, and defending commercial interests rather than browbeating them, the investment banks' sins notwithstanding. Without this political will and ability to defend our intellectual property, our economy is toast.

Let's be clear: I am not suggesting for a heartbeat that the US mimic Chinese or Japanese interference in markets or trade. But I believe we will have to push very, very hard to extend the force of our intellectual property laws worldwide. In effect, we need a reverse Foreign Corrupt Practices Act - just as US companies are restrained from bribery overseas, overseas companies stealing IP should be restricted from doing business in the US. The current situation, where we allow pirates to compete with legitimate enterprises for our markets, is ridiculous.

In the meantime, given tremendous capacity expansion with a focus on providing jobs, the Chinese and their Asian competitors will be left with no choice but to cut margins to the bone. So the ONLY question for US stock picking will become, 'Are the margins defensible?' That will lead to vastly differentiated performance between companies. And the defensibility of margins will rely on the creation and protection of proprietary processes. Just as trade routes were once defended and buccaneers[1] were set out to attack the competitor's ships, now 'patriotic hackers' are put upon the competitor's servers. I would not be surprised if the PLA's incentive plans have something in common with England's 'marques' issued to pirates in the seventeenth century. Jim Rogers should translate 'Scratch a Brit, find a pirate' into Mandarin with a first person reference. US companies unable to protect margins will find equity wiped out. This is going to be no less intense a war than the cold one with the USSR. About time investors woke up to it. Everyone on CNBC worries about the stimulus running out. That will prove to be the least of this market's problems - it was focused on state government union payrolls, not on support of private enterprise.

Firms like Wal-Mart, which controls a sophisticated supply chain into the US, or IBM, which has woven product and services into a highly competitive combination, seem like natural survivors. Business models that require intellectual property to be exposed, like Red Hat (linux), make me wonder about their multiples. Private equity's romance with China is getting riskier. It might prove as profitable as LTCM's spread trades.

Across the globe, valuations still reflect a focus on near term revenue rebound rather than margin defense. Only when multiples reflect defensible margins, not those created by cutting capex below maintenance and tossing half your staff out the window, will equities bottom. European margins will face even more intense pressure as artificial barriers, no doubt many the result of qui pro quos, collapse in the face of desperation for revenue, overwhelming gerrymandered market power.

Our models are structured to weigh valuation towards a company's technological or marketing edge. Such an edge used to last for years, if not decades. Going forward, it will become an important task to examine changes in marginal costs quarter to quarter, and see if the buccaneers managed to scale the sides of the ship, or scuttled it outright.

[1] http://en.wikipedia.org/wiki/Buccaneer