

KICKING THE CAN DOWN THE ROAD OF CAPITALISM

Stock markets around the world declined in the second quarter of 2012 as global investor anxieties were heightened on three major fronts: 1) the banking and sovereign debt crisis in Europe, 2) slowing economic growth in the United States and 3) a potential hard landing in China. The world faces major structural issues as growth is dependent on increased spending but the major segments of the global economy are facing issues which impede significant spending: 1) American and European consumers are hamstrung by high debt loads and high unemployment, 2) businesses are afraid to make major capital and human investments due to a lack of confidence in forecasting economic growth prospects and 3) American, European and Japanese governments are reducing spending and raising taxes to lessen the magnitude of chronic budget deficits. In addition, record low interest rates in the United States, Europe and Japan have been ineffective in stimulating their respective economies. Although the recent past and current environment appear less than robust, equity markets forecast six to twelve months forward and powerful weapons in government policymakers' arsenals can still be reloaded to potentially rescue the ailing global economy.

The traditional Keynesian economic spending growth model of $C + I + G$ (Consumer spending + Business Investment spending + Government spending) in the highly industrialized countries has been crippled by the Great Recession of 2008-2009. The problem has been exacerbated by the inability of central banks to stimulate their economies with record low interest rates. Despite low rates, banks have become ultraconservative in making loans while consumers and businesses either cannot obtain loans, have no appetite in taking out new loans for home purchases and business expansions, or are deleveraging their balance sheets, proving you can bring a horse to water but you can't make it drink.

The whole weight of the capitalistic world now rests solely on the shoulders of the governments' monetary policymakers. Since conventional low interest rate policies have failed to attain their traditional stimulative objectives, the four major central banks of the United States, Eurozone, United Kingdom and Japan have been forced to implement unconventional Quantitative Easing (QE) policies involving massive asset purchases and uncollateralized lending while utilizing paper money printing presses and electronic credit creation facilities for funding. These actions injected enormous liquidity into the global financial system which fueled the global equity bull market from 2009 to 2011. However, the tires of the capitalistic car are still leaking air and require periodic air injections, i.e. additional unconventional reflationary programs, to avoid all four tires going completely flat. The dilemma for central banks is that over time the holes in the tires grow larger and each succeeding QE program needs to be larger as its stimulative impact has less bang for each additional printed dollar/euro/pound/yen while the time between QE programs grows shorter.

The European Central Bank (ECB), led by a new progressive president, provided its commercial banks with unlimited loans at ultra-low interest rates for three year terms under its Long Term Refinancing Operation (LTRO) in December and again in February. Unfortunately the problems in Greece, Spain and Italy continue to fester so if a new financial crisis erupts in Europe we would tend to expect that the ECB and/or its supranational bailout funds (European Financial Stability Facility, European Stability Mechanism and/or the International Monetary Fund) would provide additional liquidity to the

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problematic banks and/or weak sovereign nations to circumvent a disintegration of the Eurozone and the Euro.

The U.S. Federal Reserve Bank implemented its first massive QE program in March 2009 which was followed by its second QE program in November 2010. Since GDP growth is still languishing at 2% while the unemployment rate exceeds 8%, we would tend to expect a third QE program to be announced if economic conditions in the U.S. or Europe deteriorate dramatically.

China has been fighting an inflation problem for the past two years with tight fiscal and monetary policies. However, their economy is approaching recession levels so the government has reversed course recently and has implemented stimulus policies which have included multiple reductions in their prime interest rate and bank reserve requirements and the approval of more infrastructure projects. Unlike the United States, Europe and Japan, China has \$3.2 trillion in foreign exchange reserves which can be tapped to fiscally stimulate its economy. In addition, China's largest banks are state controlled so if the government instructs the banks to increase their lending activities then the banks will be expected to follow the government's instructions. Unlike American, European and Japanese horses, Chinese horses will drink the water.

In conclusion, central banks of the United States, Eurozone, United Kingdom, Japan and China are faced with two ugly options: 1) not to continue with aggressive conventional and unconventional monetary easing policies, and risk potentially higher short to intermediate-term unemployment rates which might lead to social dissatisfaction/instability and national leadership/regime changes or 2) continue with aggressive conventional and unconventional monetary easing policies, and risk potentially higher long-term inflation rates. Selecting the first option would effectively be biting the bullet in which case the unemployment rate could possibly rise from 8.2% to 10% in the United States and from 11.1% to 15% in the Eurozone while in China this option could usher in another cultural or peoples revolution. We are of the opinion that this option would be too painful for central bankers so prolonging the current economic expansion with further massive asset purchases, unsecured lending, money printing, electronic credit creation, debt monetization and interest rate reductions would be the logical choice for monetary authorities. However, the price the world would have to pay for continuing to kick the can down the road for an undetermined period of time would most likely be higher long-term inflation rates as the world's outstanding quantity of uncollateralized paper money and credit would steadily increase in excess of nominal global GDP growth. The creation of excess liquidity in the global financial system by the central banks would continue to debase the perceived value of fiat money and would over the long term create inflationary pressures which could favor inflation hedge assets such as WHV's energy and materials investments.



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