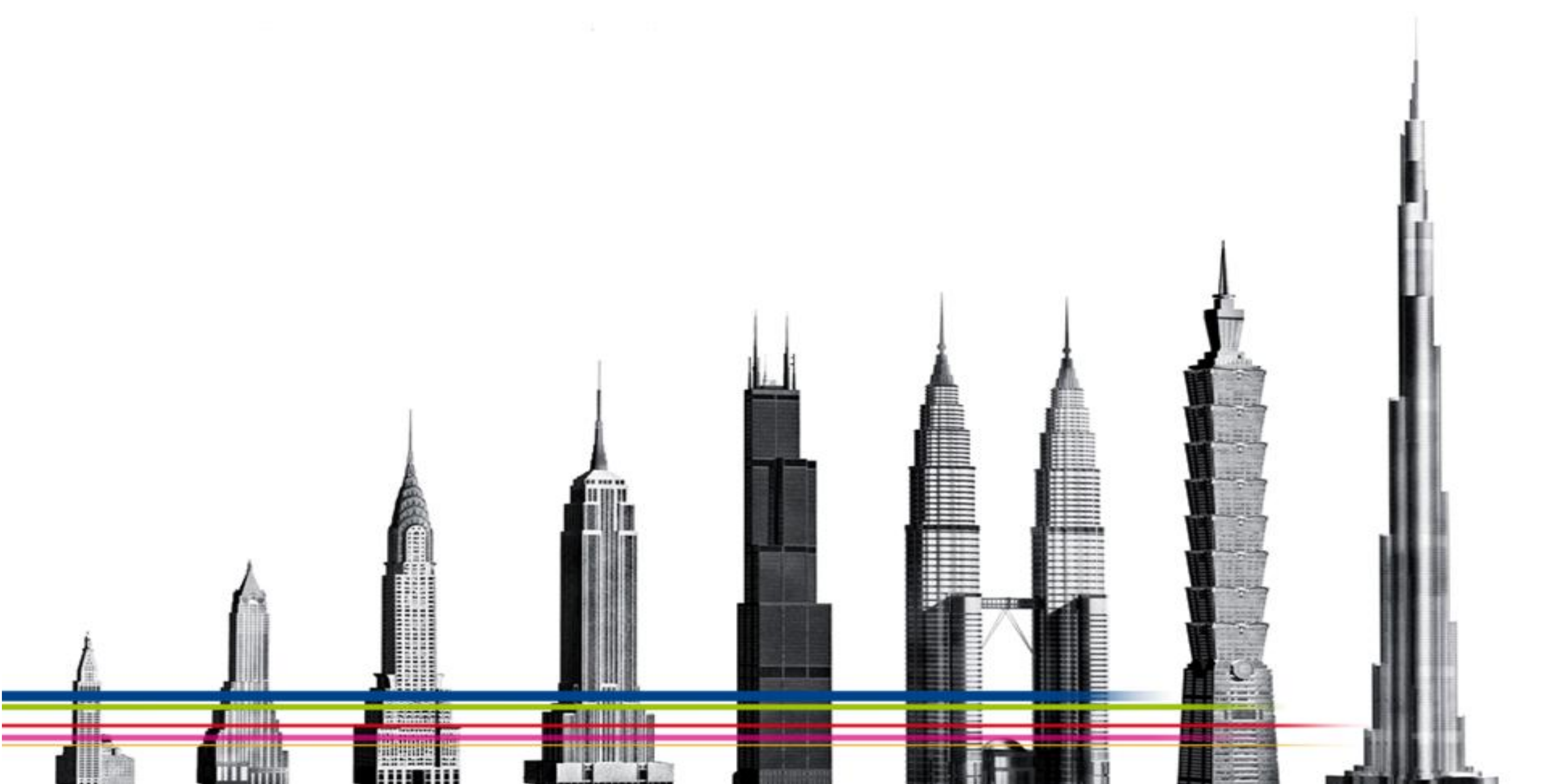
NEWSLETTER

Market Comments

June 2012

From

Mete Sarper



Dear All,

I thought I would share some notes from Nomura's "Asia on Asia" conference in Singapore earlier this June and make this the Q2 "Investors Letter". I was able to participate to Mr. Richard Koo's presentation on what he describes the "Balance Sheet Recession", the father of this concept following the Japanese Balance Sheet Recession of the early 90's. Mr. Koo also advises panels on most Central Banks around the world, not least the Europeans and even the Fed.

I have attached charts and diagrams of his presentation to my text which I have no doubt make some very interesting points.

I will attempt to summarize the core view about why policy risks are at a crucial point, and the measures that need to be adopted by politicians rather than Central Bankers, who have done what needed to be done.

The Balance Sheet recession had started in the US well before the Lehmann default. Today, the eurozone and the US are in the midst of this recession. What it basically boils down to is simple: when households, along with corporates stop borrowing and start paying down debt even at historically low interest rate levels, the governments' decision to chose austerity measures and fiscal tightening is plain wrong. In essence, this means that a deleveraging is occurring, and when this happens, growth cannot occur. If added to this deleveraging, when governments express deleveraging policies (as France, Germany, Netherlands, USA...) as well by ways of budget cuts, tighter fiscal policies; there will be no way out for decades to come.

The example of Japan in the early 90's when the Balance Sheet Recession went on for 10 years, real estate (and prime land) assets suffered a reduction of 86% in a matter of few years but this didn't result in the japanese GDP to meltdown. Actually, the real and nominal GDP continued to grow, albeit at a slow pace, but nevertheless grew. Why? Because, the government realized that they had to fill in the gap of the households and corporates' deleveraging by becoming borrowers and by increasing public spending. This was actually done through the unused savings stocks of Japanese households.

Here, one can see the close similarities of the US Housing and Commercial Real Estate prices compared to Japanese prices and why the US and the Euro zone are experiencing the "Japanese Experience".

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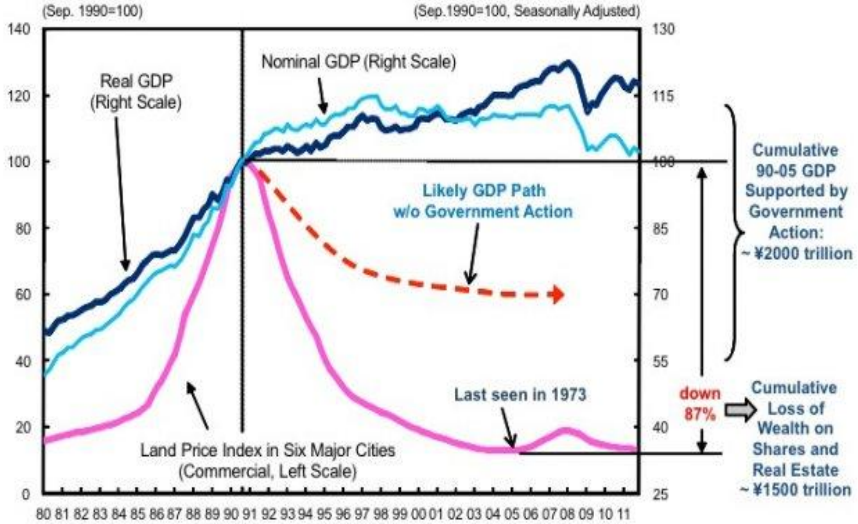
Exhibit 12. Japan's GDP Grew in spite of Massive Loss of Wealth and Private Sector De-leveraging



Sources: Cabinet Office, Japan Real Estate Institute

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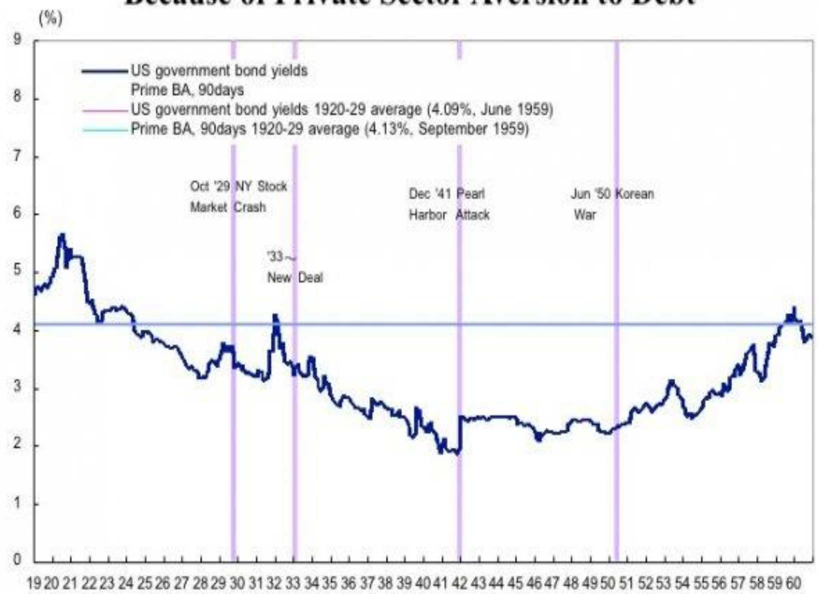
Exhibit 38. Exit Problem (III): U.S. Took 30 Years to Normalize Interest Rate after 1929 Because of Private Sector Aversion to Debt



Source: FRB, *Banking and Monetary Statistics 1914-1970 Vol.1*, pp.450-451 and 468-471, Vol.2, pp.674-676 and 720-727

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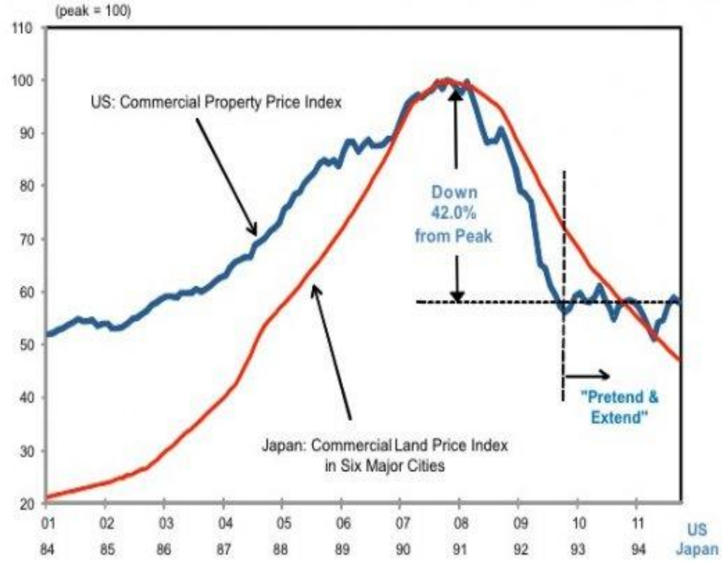
Exhibit 2. US Commercial Real Estate Prices Also Falling to Japanese Levels



Note: Peak of US Prices: Oct. 2007, Peak of Japanese Prices: Sep. 1990.
Source: Nomura Research Institute, based on Moody's/Real Estate Analytics and Japan Real Estate Institute

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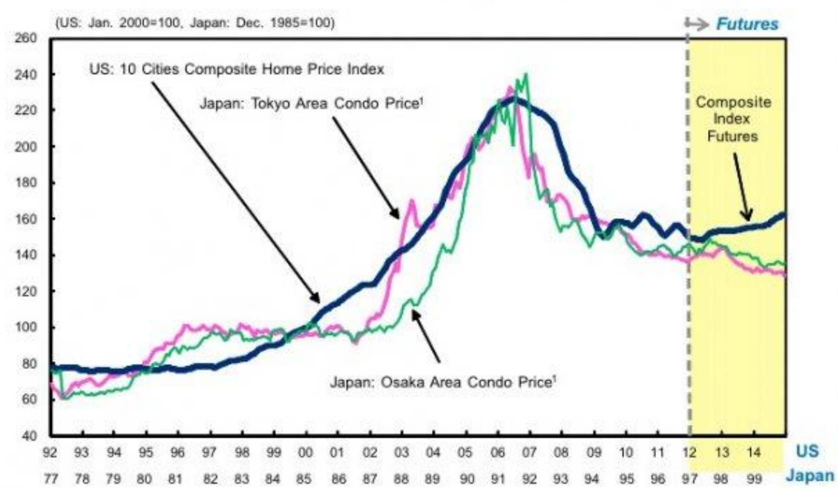
Exhibit 1. US Housing Prices Are Moving along the Japanese Experience



Note: per m^2, 5-month moving average
Sources: Bloomberg, Real Estate Economic Institute, Japan, S&P, S&P/Case-Shiller® Home Price Indices, as of Mar. 23, 2012

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The problem with this case in Europe is unfortunately the non-existence of a one currency one bond structure. As in Japan or USA, debt issuances are bought by pension funds and others because liquidity needs to be parked somewhere. When market participants don't want any more cross currency risk or principal risk, best thing to do is to buy your own national debt in local currency. However in Europe, the one currency, 20 countries debt issuance caused partly today's sovereign debt problem. The sovereign debt problem is not due to over borrowing from countries, especially not those of Spain in particular (debt to GDP is around 60%, much lower than USA...).

Why? because in the early days of the Euro zone, German, Dutch and other fund managers were looking for yields and bought peripheral euro debts of countries such as Greece, Spain and Portugal who were offering a greater premium than Germany's Bunds. Fast forward to today, not only the money has moved out of those countries' debts due to loss of confidence pushing yields massively up, now the Spanish fund manager is using the Spanish savings to buy Bunds for its safety, thus the Spanish yields are increasing for lack of buyer.

If Europe had a Euro land Bond, Spanish yields would be trading in the 3% region today, according to Mr.Koo.

The principal idea of the Euro land Bond is to permit European nations to borrow under one fiscal pact, where each nation depending on the debt to GDP ratios can borrow so many billions. If the budget is exceeded and more debt is needed, they would have to tap the markets by debt issuance in the same way they do today. This would come with a premium, but the average of the debt servicing would be hugely lower. We would not be facing a sovereign debt crisis in Europe in such a scenario, as Japan did not have a sovereign debt crisis with its ballooning debt. However, Greece is the exception to this view.

<u>Past 101 Economics</u>

The basic economics we were taught were: lower interest rates, looser fiscal policies result in households' higher spending, corporates increased borrowing, resulting in GDP growth.

When economies heat up, interest rates go higher, money gets pulled from markets, resulting in higher savings, lower borrowing and cooling down of growth.

Also, lose monetary and fiscal policies risks were to drive inflation to higher levels, the greatest evil of what to avoid in the old days.

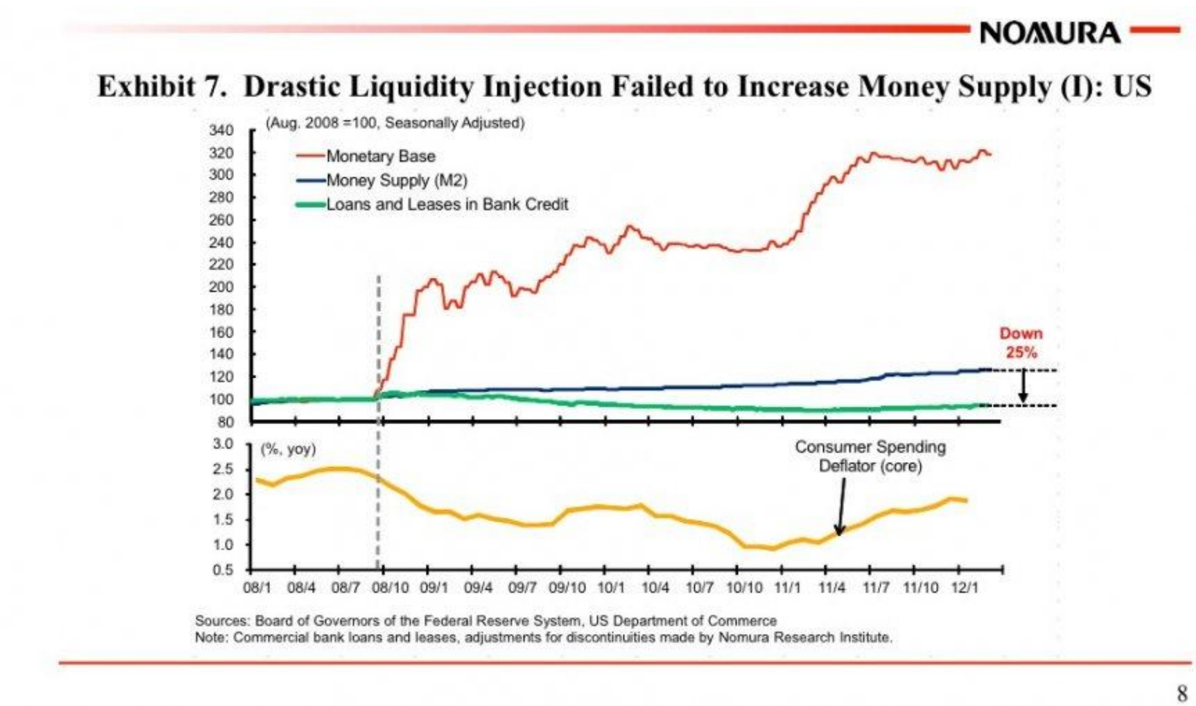
These days, we often hear about huge inflationary risks ahead due to the trillions of dollars being injected in to markets. Actually, trillions of dollars or Euros have already been pumped in the market since 2009. What those who claim such inflationary statements forget the term: "Velocity of Money", basic 101 Economics. Here are some figures on where we stand:

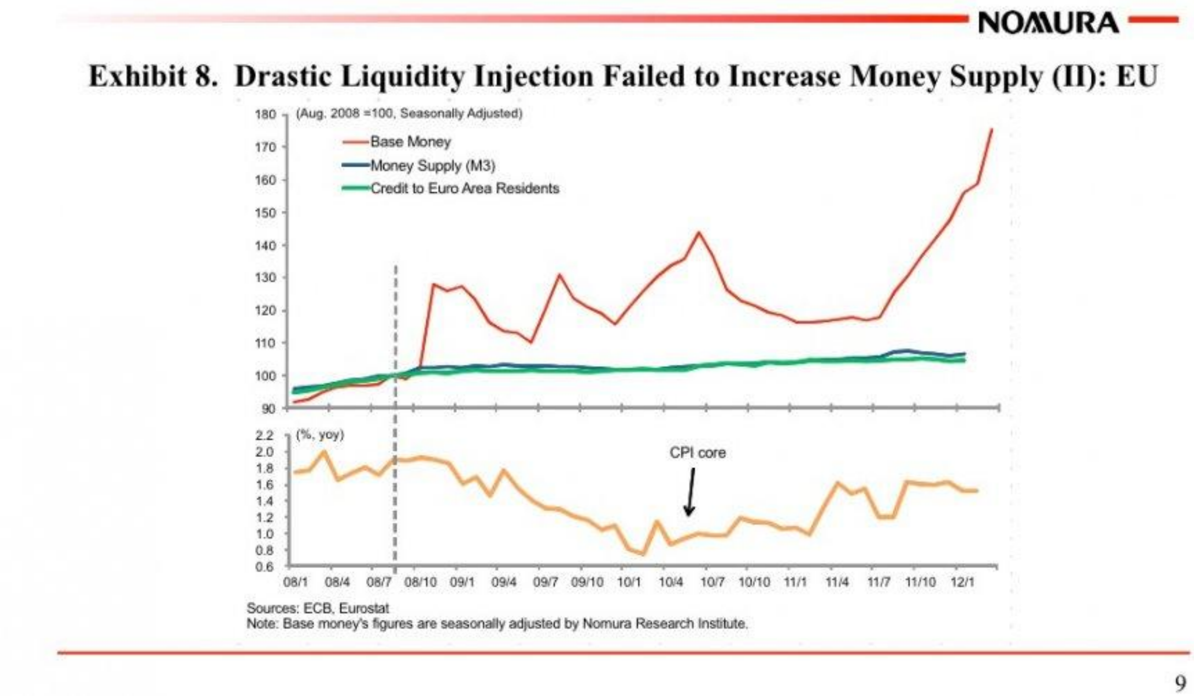
Since 2008, the Monetary Base in Europe increased 3 fold. This was 100 in 2008, today 327!

M2 (measure of money supply) went from 100 to 127! Loan and leases -24%...Again, 101 economics taught us when the money base increases, M2 would increase almost at the same pace. No such thing today. 101 economics taught us that lower interest rates increases the propensity to spend: not only it is not happening but it is in negative rate!

The UK expanded its monetary base from 100 in 2008 to 355 today. M2 went to 100 to 105 in the same period!

These 2 charts sum up the liquidity injection versus the failed Money Supply increase:





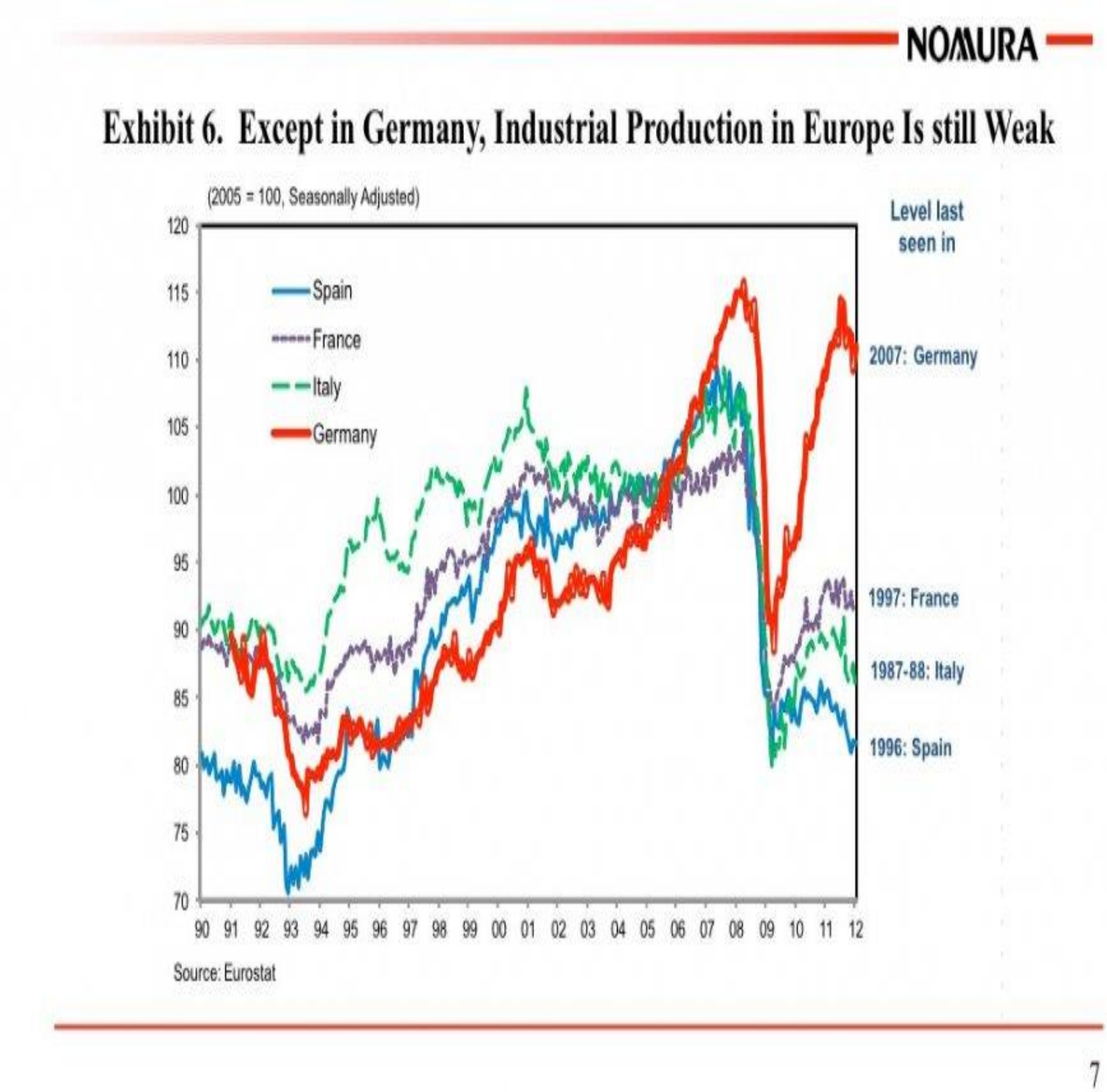
I will share just another set of data (all of which you will find in the presentation) on industrial production in Europe's biggest economies.

France is at the same level of industrial production as in 1997.

Italy same as in 1987-88.

Spain same as in 1996.

Germany.....same as...2007! And, historically Germany is at its LOWEST unemployment rate. I ask myself, why the Germans would let the euro land go bust?



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Talking about a lost decade? Maybe even bi-decade in some cases. The problem is this can go on for another 10, 20, 30 years if policies are not addressed now to cure the problems. At the beginning of last year I was pointing as the greatest risks we faced in coming years in the markets was "Policy Risks" from politicians and governments. Today, central bankers are urging governments to do their bit: loosen fiscal policies, increase public spending to give growth a chance. Austerity measures by governments accompanied by loser monetary policies by central bankers just cancel each other out.

The conclusions that I withdrew from Mr. Koo's presentation, along with what I know about the markets and my personal views about what to expect going forward that I made known to most of my client base:

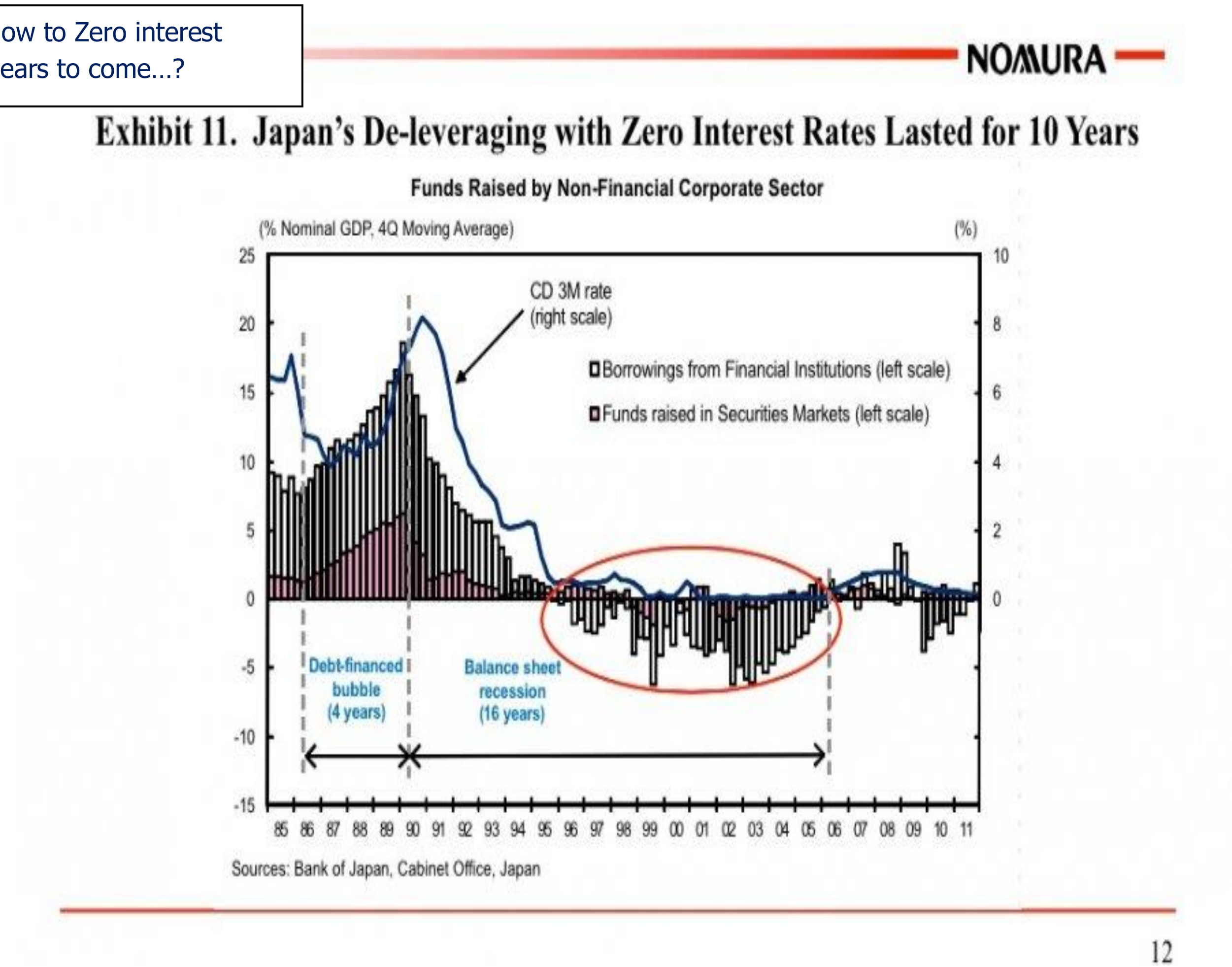
Volatility ahead? certainly.

Low interest rate environment for years to come? Most likely.

More QEs, Twists, expanding monetary base? almost a given.

Then, overweighting fixed income should be the main beneficiary of prudent asset allocation, choosing well periodically between high grades and high yielders. Gold is once again a favorite, however, would lose traction if right policies are adopted. Equities should also be attractive as QEs would support prices and growth spurring policies start to come through.

A case of low to Zero interest rates for years to come…?



More ECB liquidity through easing?
Why not?

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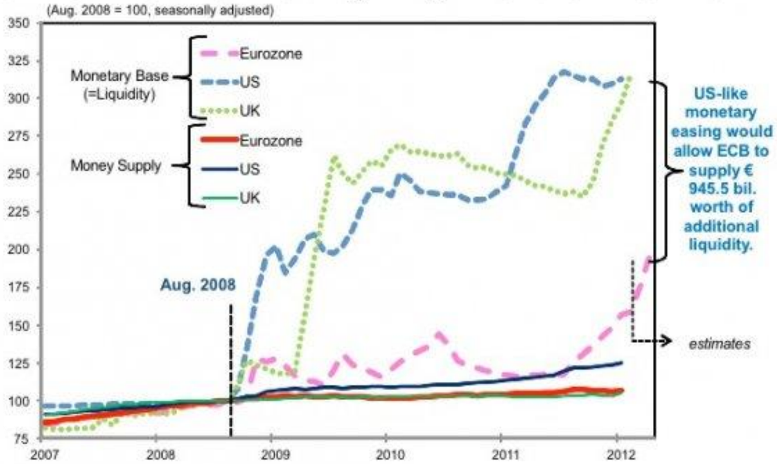
Exhibit 31. ECB Facing Balance Sheet Recession Can Supply Large Amounts of Liquidity without Igniting Inflation



Notes: 1. UK's reserve balances data are seasonally unadjusted.
2. UK's money supply and bank lending data exclude intermmediate financial institutions.
3. Base money's figures of Eurozone are seasonally adjusted by Nomura Research Institute.
Source: Nomura Research Institute, based on FRB, ECB and Bank of England data.

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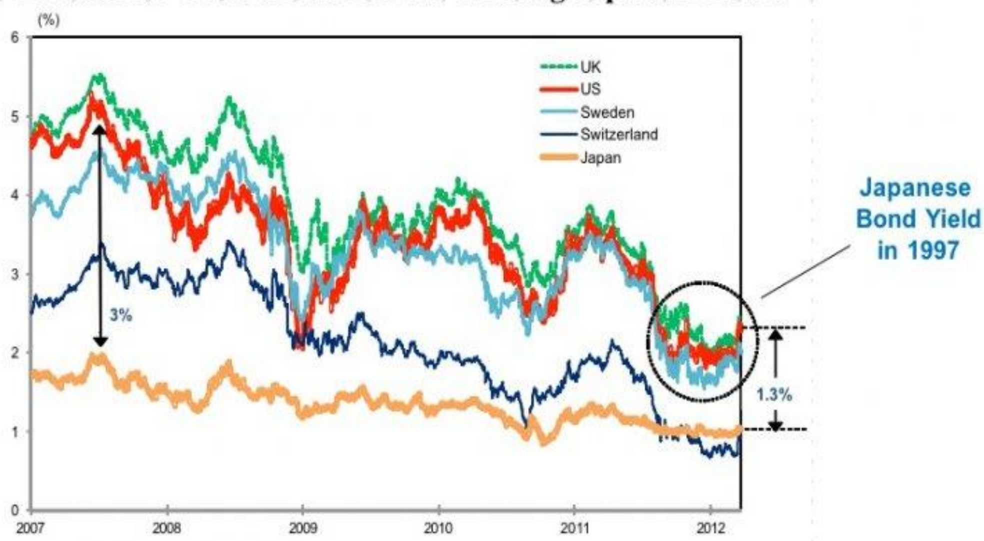
Exhibit 17. Global Bond Yields* Nearing Japanese Levels



*Note: Excluding Eurozone. As of Mar. 22, 2012.
Source: Bloomberg

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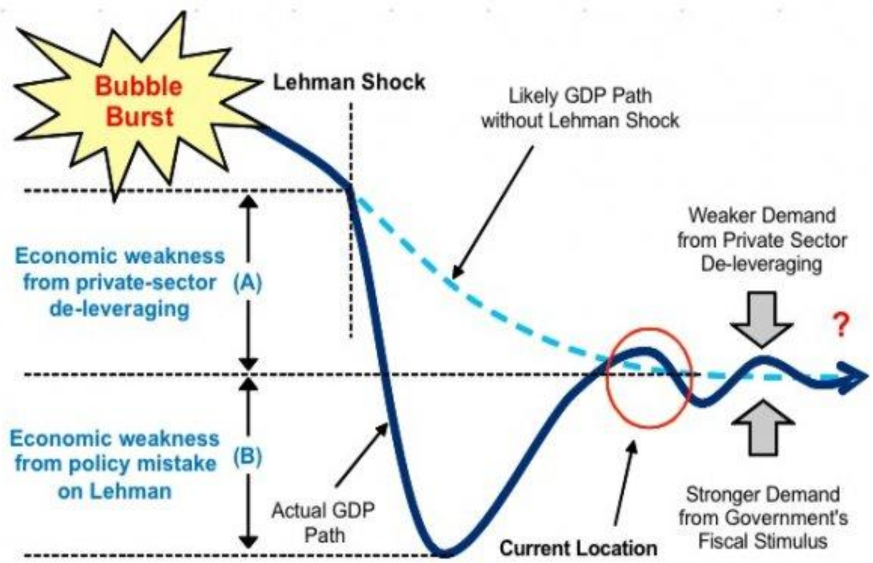
Recovery from Lehman…

Exhibit 41. Recovery from Lehman Shock Is NOT Recovery from Balance Sheet Recession



Source: Nomura Research Institute

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Finally, the Yin Yang Cycle and contrast…familiar path!

RAM Capital
WEALTH WORKING

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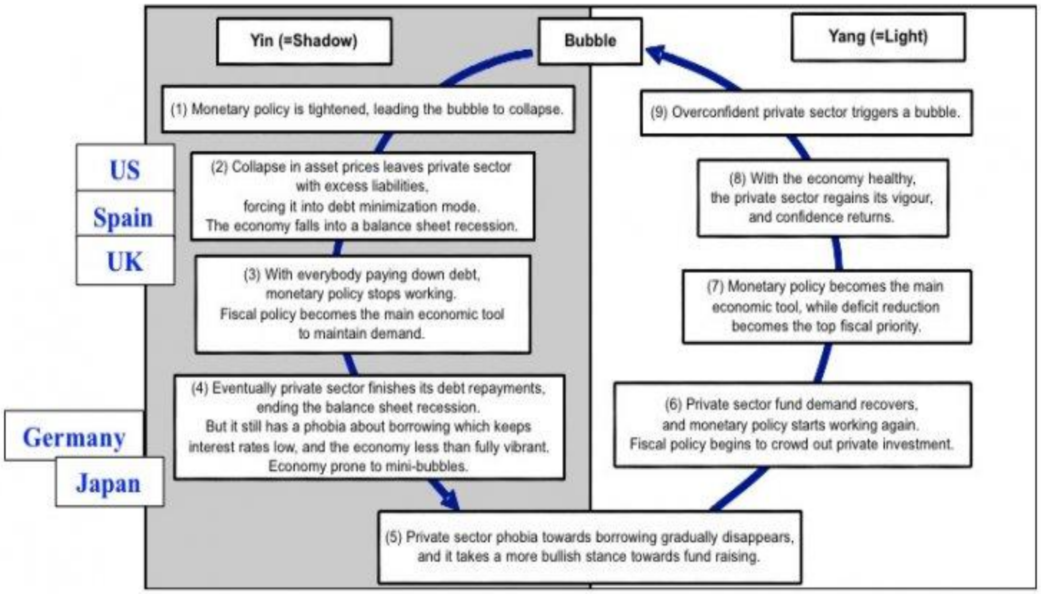
Exhibit 42. Yin Yang Cycle of Bubbles and Balance Sheet Recessions



Source: Richard Koo, *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession*, John Wiley & Sons, Singapore, April 2008 p.160.

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Exhibit 43. Contrast Between Yin and Yang Phases of Cycle

	Yang	Yin
1) Phenomenon	Textbook economy	Balance sheet recession
2) Fundamental driver	Adam Smith's "invisible hand"	Fallacy of composition
3) Corporate financial condition	Assets > Liabilities	Assets < Liabilities
4) Behavioral principle	Profit maximization	Debt minimization
5) Outcome	Greatest good for greatest number	Depression if left unattended
6) Monetary policy	Effective	Ineffective (liquidity trap)
7) Fiscal policy	Counterproductive (crowding-out)	Effective
8) Prices	Inflationary	Deflationary
9) Interest rates	Normal	Very low
10) Savings	Virtue	Vice (paradox of thrift)
11) Remedy for Banking Crisis — a) Localized	Quick NPL disposal Pursue accountability	Normal NPL disposal Pursue accountability
11) Remedy for Banking Crisis — b) Systemic	Slow NPL disposal Fat spread	Slow NPL disposal Capital injection

Source: Richard Koo, *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession*, John Wiley & Sons, Singapore, 2008

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