HindeSight

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The source of the global crisis through which we are living can be found in the great trade and capital flow imbalances of the past decade or two. Unfortunately because of payments mechanisms are so poorly understood, much of the debate about the crisis is caught up in muddled analysis.

Michael Pettis (2012)

A country that appears peaceful and stable may encounter unexpected crises. There are structural problems in China's economy which cause unsteady, unbalanced and uncoordinated and unsustainable development.

Premier Wen Jiabao (2007)

Executive Summary

The global crisis is a financial crisis driven primarily by global trade and capital imbalances. This is the macro theme we have pursued these past 7 years. We believe the global crisis is in full swing again and asset prices are in danger of falling globally. Money is less effective at catching the falling knife.

Emerging market countries are exhibiting the signs of crisis-like price action associated with deteriorating balance of payment balances, even though many have built up significant foreign exchange reserves.

Investors and policymakers do not believe this is the beginning of a major EM contagion crisis. They are lulling themselves into a false sense of security. They see the EM market tremors, and do not fear a re-run of the EM crises of old. They are right. This is not (just) going to be an EM crisis. Recent events portend a far more serious crisis is at hand; the unravelling of our global monetary system.

The crux - the EM tremors are really signifying the demise of the credit bubble that began bursting in 2008. This is not the start of the EM crisis. It is the beginning to the end of a credit bubble collapse that began in 2008.

We have witnessed unprecedented global fiscal and monetary stimulus (QE) which was used to arrest a global credit deflation. This led to the development of a truly global bond bubble. As debt levels rose in the developed countries and monetary stimulus was exported (de facto QE) to EM countries it underpinned growth with excess credit.

Since 2003 EM countries have seen US$7 trillion of inflows into their countries and a commensurate appreciation in their currencies; ones that they have struggled to control. These are not just strong flows rather they are astronomical in size and have been achieved by this excessively loose and unconventional monetary policy.

The paradox of such inflows strengthening currency rates is that they have succeeded in stultifying EM export-led growth, despite this supply of credit. The commodity exporters amongst them have been left doubly reeling by the confluence of higher exchange rates and lower demand from a stagnating global economy and in particular China. They have all seen their commodity revenues fall precipitously.

In a re-run of the 1990s the appreciation of the dollar against a rapidly depreciating yen has begun to drag USDAsia higher. This was the trigger for the Asian Tiger currency crisis in 1997. This has been a final nail in the coffin of Sino imperialism, as their export competitiveness is lost too.

In the 1980s it was a hike by the US Fed that triggered the LatAm crisis. Today, the mere whisper of tighter monetary conditions in the US, vis-a-vis a tapering of QE has led to higher bond rates globally. Note tapering is not the same as hiking interest rates.

The consequences of multiple rounds of QE have heightened global risks as it has both exacerbated 'currency competition' and hot capital flows into countries seeking desperately for a return both from income and capital growth. This has created major distortions in term rates, equity and bond values, driving them artificially high in price.

These distortions have created risks far greater than the fragilities of EM countries of yesterday years. The system of credit creation has produced unstable growth underpinned with collateral which is both mobile and suspect in its integrity.

Investors have nowhere to turn, emerging market countries growth is faltering in response to export disadvantages brought about by rampant G10 currency devaluations. China is finally succumbing to its side of the global imbalance excesses. First it was the deficit nations now it's the turn of the creditor nations to falter, primarily China.

Trade flow reversals are leading to massive capital outflows out of EMs and the question remains will the central banks of these countries sell their FX reserves, UST-bonds and euro government bonds (bunds) to finance this surge in outflows.

It is not clear that renewed global central bank liquidity provision will even stabilise a situation we see as growing dire by the day. China is the driver. All eyes on China.

Hey! Ho! Let's go!

The Anatomy of a BWII Crisis

Signs the Music are 'Sudden Stop'ping

The Final Outcome

Introduction

Over the past four decades the global economy has largely experienced prolonged imbalances, with countries running large current account deficits in symbiotic relationships with those running large surpluses. In this letter we revisit our long held belief that the current monetary order as defined by a constellation of exchange rate arrangements between the major global currencies, and which maintained these imbalances artificially, has led to excessive global liquidity and credit creation. This in turn drove a litany of asset price bubbles.

The bursting of these asset bubbles has continued in a series these past two decades, each one's demise leading to more disruptive policy responses which have only succeeded in igniting yet more bubbles, only for those too to fail.

Finally in 2008 we witnessed the finale of decades of credit creation, rising in what appeared to be a crescendo of credit excess and widespread asset booms. We saw this event as the death throes of an unstable monetary regime, only then to see an unprecedented global reaction by policymakers in a coordinated fashion to keep the global system alive. For a moment here today, there are those who dare to believe they have succeeded, with rising equity markets a testimony to a reviving global economy. Nothing could be further from reality.

We stand by our assessment that the disproportionate reaction of central bankers and policymakers alike has merely succeeded in compounding and exacerbating the error of this highly imbalanced monetary system. Recent events in emerging countries are a manifestation of the continuing unravelling of our monetary order.

In a recent HindeSight letter we described how the world is faced with a binary situation of global deflation or hyperinflation. We believe the odds have tilted firmly towards deflation. It would appear the unwinding of the global imbalances that led to the 2008 crisis is continuing unabashed, irrespective of the recent monetary excess used to abate them.

Large current account deficits led to unsustainable debt creation and as a consequence the trade deficit countries were the first to experience a severe financial crisis, but now on the other side of the equation the surplus countries are experiencing their reaction to the crisis. For balance of payments have two components to the equation both the financiers and the borrowers, so by definition changes in savings and investments in one such country has a profound impact on those of another.

The recent instability in emerging market economies and especially China is a direct consequence of these global imbalances which became stymied briefly by global bail-outs only to have been left in a more vulnerable economic position. **The deleveraging process which began in 2008 has been a slow burner but is likely now in full swing. The deflationary risks are very high.**

Hey! Ho! Let's go!

Top of the Pops was a legendary British music chart television show which began weekly broadcasts on the BBC in 1964, and finally wound down its music decks in July 2006. The show comprised performances from leading selling music artists and always culminated with an airing of the number one best selling single of the week, after a rundown of the top 30 singles. So popular was the show that it became a major UK export franchise, with its iconic logo emblazoned over TV screens globally.

Like all great cultural institutions the music was both a representation and manifestation of its ages, shaping popular culture and generations alike. No more emblematic of its age were the Punk rock bands of the 70s, both here in the UK and the US; the 'Sex Pistols' and 'The Clash', the UK vanguard, and across the Atlantic the 'Television' and the 'Ramones'. Hard-edged, shouted vocals amongst a cacophony of relentless drumming, heavy bass and repetitive electric guitar chords, they bore witness to an anti-establishment movement seemingly disenfranchised with the economic misery of the time.

'Blitzkrieg Bop' by the Ramones exemplified the mood of the era, its title inspiration coming from the German World War I tactic, *blitzkrieg*, which literally means 'lightning war'. Drawing our own inspiration from *Blitzkrieg Bop* we echo their rally cry - 'Hey! Ho! Let's go' as we re-delve into the area of global imbalances which seems to have taken a back-seat in the debate on the continuing crisis these past few years. We will observe those countries with vulnerable balance of payments in our very own version of Top of the Pops, Top of the BoPs (Balance of Payments) if you will, to see which are exhibiting financial and trade stresses.

Over our career we have found balance of payment imbalances to be a superb leading indicator of economic stress, both in the emerging and developed markets, by which we could make investment and trading decisions. They are the thermometer by which we can first observe the very real signs of a monetary system in turmoil. In keeping with our musical theme, we wanted to make reference to another iconic UK show, but this time that of BBC radio and not TV; it's called Desert Island Discs.

Desert Island Discs marginally pre-dates the auspicious events of the Bretton Woods conference of 1944, when allied nations gathered in New Hampshire to formulate the terms of an agreement on how to regulate the international monetary system, after the likely conclusion of World War II. The show began in 1942 and endures today, each week inviting a distinguished guest to envisage that they are a castaway on a desert island; who having chosen eight pieces of music, a book and a luxury item to take with them to the island are then asked to review their life in reference to excerpts of these choices.

Although not quite existing as long as the show, (according to the Telegraph it's the longest running radio show in the UK), if we at Hinde Capital were to be castaway on a desert island, in our own version of the game Desert Island Economic Discs* - the ten macroeconomic 'records' we would take with us as an excerpt to a life, in this case a country, would be:

1. Current account balance as a % of GDP (and commensurate capital account)
2. Debt as % of GDP (Debt composition as % of GDP)
3. Current account balance as a % of Investment
4. Real Effective Exchange Rate
5. Stock Prices
6. Exports
7. M2/ reserves/ Domestic Credit
8. Output
9. Short-term capital inflows/GDP
10. Real interest rate on bank deposits

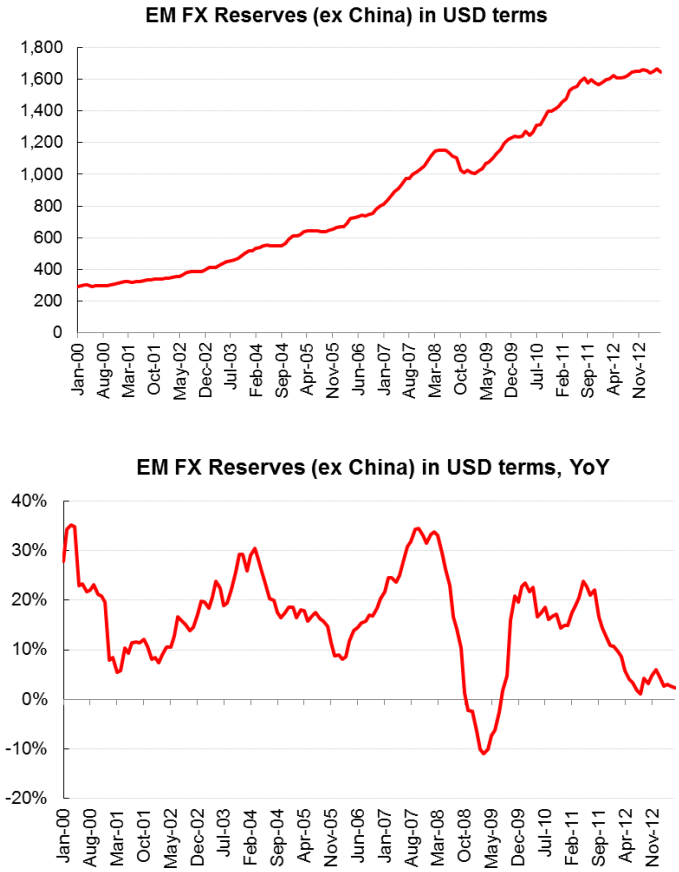
*(We would mention here that a Deutsche bank team have made a similar analogy, good ideas are not exclusive we are afraid.)

The countries which make our Top of the BoPs, are mainly those of the Emerging Markets. These countries are all exhibiting the hallmarks of a classic balance of payments (BoPs) crisis which have built up over many decades.

These large and persistent trade imbalances have been caused by distortions in financial, industrial, and trade policies. These distortions have prevented adjustments for many years, but large imbalances ultimately are unsustainable because the capital flows that finance the trade imbalances can be reversed only with a reversal of trade imbalances. **Eventually these imbalances will adjust in spite of policy and institutional constraints, but in this case the adjustment is often violent and can come in the form of a financial crisis.**

The recent events in the EMs are a manifestation of this adjustment, which began in 2008. As China's trade flows reverse so are the capital flows that have funded the whole of Asia and LatAm reversing. LatAm is responding to the collapse of China as its number one commodity export market falters.

The reversal in flows has led to FX Reserve growth slowing in China and in all EM countries.



Source: Variant Perception

The Anatomy of a BWII Crisis

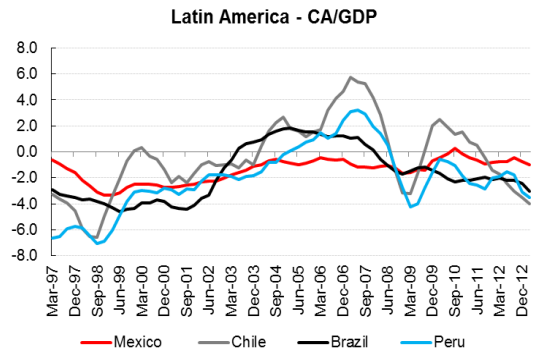
In many ways the title of this letter is misleading. We are not witnessing a traditional balance of payment crisis across the globe but a crisis borne out of balance of payment issues which encompasses both deficit and surplus countries. It is the continued unwinding of these imbalances that we are observing again today.

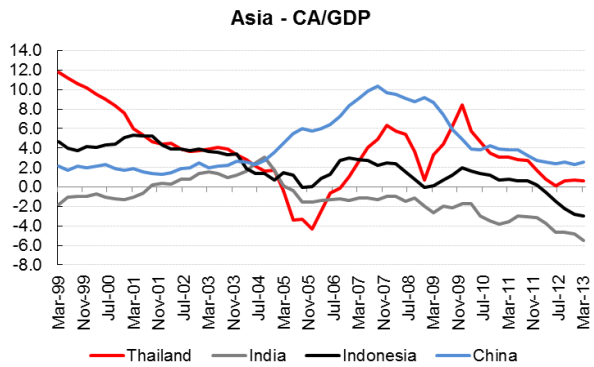
The Washington Consensus has been not to be worry about global imbalances, where countries which have built up large current account deficits and have increased their debt, and likely have seen foreign ownership of their assets. We know much of what happens to current account deficits but what is the scenario when the surplus country experiences trouble? Well, we are witnessing the fall-out from the internal rebalancing of China – the major surplus country in our current monetary system.

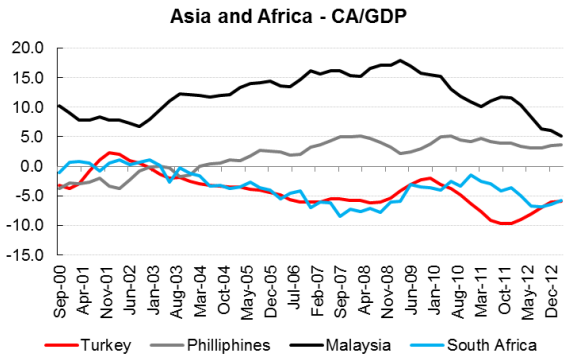
Historically candidates for balance of payment crises are invariably associated with EM countries, 1982 Latin America, 1994 Mexico (Tequila) crisis, 1997 Asian Tiger crisis; but there have been examples of countries exhibiting classic balance of payment crises in the developing world, such as the UK in 1992 - where a country witnesses a sudden stop flow of capital. We believe it's not just EM countries but its developed countries such as Australia who are also now highly vulnerable to their external funding exposure.

What is a balance of payment crisis?

BoP crises are invariably known as currency crises and usually occur when a country is finally unable to pay for essential imports and or service its debt repayments. The literature of currency crises is vast, ranging from first to third generation models, mainly revolving around market expectations, and self-fulfilling outcomes; ie it is the reality of non-payment or the expectation of non-payment that triggers the crisis.







Sudden Stop

Balance of payment issues often result in a 'Sudden Stop' flow of capital. The term was first introduced by Dornbusch and refers to the abrupt slowdown and reversal in private capital inflows into EM economies (primarily) which invariably leads to sharp currency depreciations in the recipient countries. These are highly disruptive events:

1. It reduces these countries access to international financial markets for a considerable period of time.

2. The loss of their external funding leads to a sharp and dramatic drop in domestic output and private expenditure as credit to the private sector dries up. The withdrawal of credit leads to an inability to fund activities and projects, and collateral values begin to fall exacerbating LTV ratios, putting more pressure on domestic borrowers. As demand for cash naturally grows as credit is withdrawn, the problem becomes a self-reinforcing dynamic.

3. The demand for foreign currency as capital flees compels the central bank to sell its FX reserves in a bid to prevent a collapsing currency peg. A substantially weaker nominal currency rate though runs the risk of importing high levels of inflation.

4. Credit stresses lead to a rise in interbank funding rates further dampening economic activity. The real effective exchange rate of the recipient country tends to rise as the countries experience a classic Fisher's debt deflation.

5. Evidence of this stress manifests itself in a dramatic fall in domestic equity, sovereign and corporate debt securities.

Calvo (2004) emphasised that financial crises were preceded by surges in capital inflows and ended in dramatic drops in output growths. He gave an empirical value to sudden stop episodes as a net capital flow larger than two standard deviations from the country's own sample mean.

Currency crisis models

A related string of literature deals with the notion of a currency crisis or more specifically: under which conditions a fixed currency regime may fall when faced with significant and persistent capital outflows. The literature customarily talks about 3 generations of currency models of which the latter two have been forged through the experience of the ERM crisis in 1992, the Mexican Peso crisis in 1994 and the Asian Crisis in 1997/98.

First generation currency crisis models – These models are the simplest models and were developed in the 1970s and 1980s. They were coined as first generation models by Paul Krugman, an American economist, in 1996. These models are essentially naïve and determinist and can only handle extremely rational and linear economic agents with perfect information and foresight. Consider then a simple example of a government running a fixed exchange rate, but also expanding domestic credit at a rapid rate. Given the assumption of a fixed and constant money supply growth (in order to maintain the peg), such a credit expansion can only occur through the depletion of reserves (otherwise the currency would appreciate). Once reserves have been depleted the exchange rate will devalue and the crisis will "occur" as a determinist and arithmetic outcome of the model's equations. However this model does not explain or take account of the fact that speculators may hasten or slow the process. It does not allow for a speculative market to provide feedback to the government's reckless policies. In addition, it does not explain why the government would run persistent policies that were in conflict with the peg in the first place.

Second generation currency crisis models – These models were developed following the collapse of the ERM in 1992 and the Sterling crisis. These models try to incorporate two crucial elements to the understanding of a currency crisis. Firstly, they ask whether seemingly solid fixed exchange rate regimes can be brought down by speculators. Arguably, Spain, France and the UK had a guarantee from the Bundesbank which meant that they could have defended their pegs. But the market did not believe that Germany would devalue to accommodate the pressure on the peripheral currencies and hence the crisis ensued. Secondly,

these models endogenise government policy which essentially means that they take explicit account of the government's decision to abandon the peg because the costs associated with defending it might exceed the costs of exiting the fixed exchange rate regime. The central element of these models is then a loss-function minimised by the government. The government will then take the course of action (defend or abandon the peg) which corresponds to the minimum loss (in terms of output growth, employment, etc). The second generation currency models thus opens up for the possibility that speculators may take down a weak or even a seemingly solid peg.

Third generation currency crisis models – The third generation currency models are not models per se but more so a framework to explain what was essentially a much more severe crisis in Asian in 1997/98. As such and even though the crisis formally started the 2nd of July 1997 with the devaluation of the Thai baht, the end result was a sweeping insolvency crisis in most of East Asia. The notion of a third generation currency crisis model is then an attempt to create a framework than can explain why a currency crisis in its strictest forms (ie a fall of a fixed exchange rate regime) can lead to a full blown cross border financial crisis. Needless to say, with the events in 2008/09 and indeed with the events discussed here, the work on such a framework is ongoing.

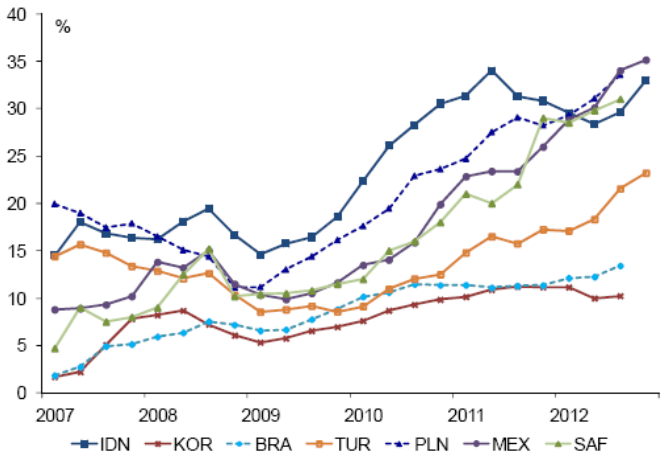
Antecedents to Sudden Stop

In determining the risks of a BoP crisis, we draw on our original 'records' taken to our desert island and narrow them down to four categories to examine:

1. Capital Flows (duration risks)
2. Original Sin (denomination risk)
3. Current and fiscal accounts as % of GDP (Twin deficits)
4. Domestic Credit (Inflows drive domestic credit)

- **Strong capital flows**: Portfolio and FDI flows can both create vulnerabilities for a country, but it's fair to say portfolio flows are more volatile as they are quicker to exit in the short-run. They are more disruptive in their reversal.

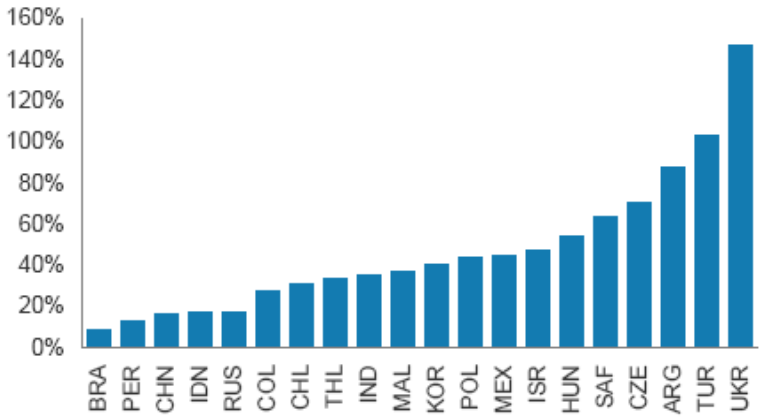
Foreign Holdings of Domestic Government Debt



Source: Deusche Bank

- **'Original sin'** refers to the issuance of bonds in foreign currencies, making them highly vulnerable to currency movements. There is a FX liability mismatch - the country receives revenue in their local currency but any interest they have to pay or principal repayment is in dollars. So if dollar rises (ie local currency depreciates) the cost of borrowing rises prohibitively.

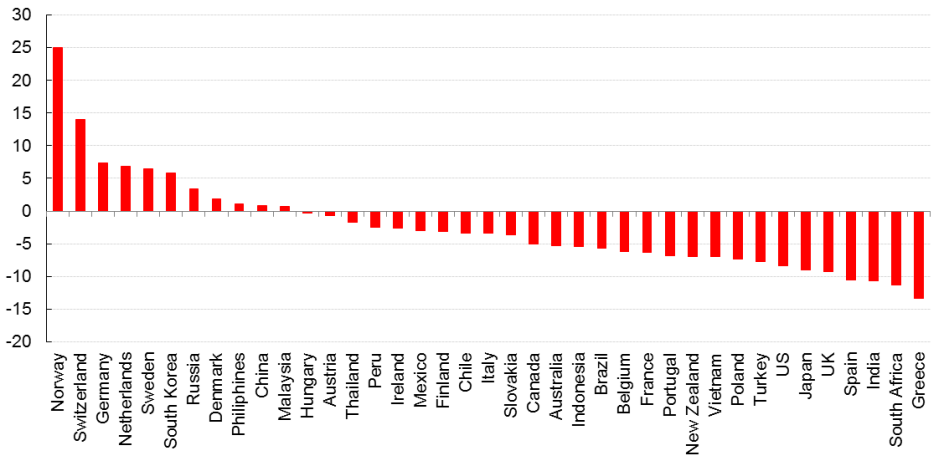
Short-term Debt Exposure as % of FX Reserves

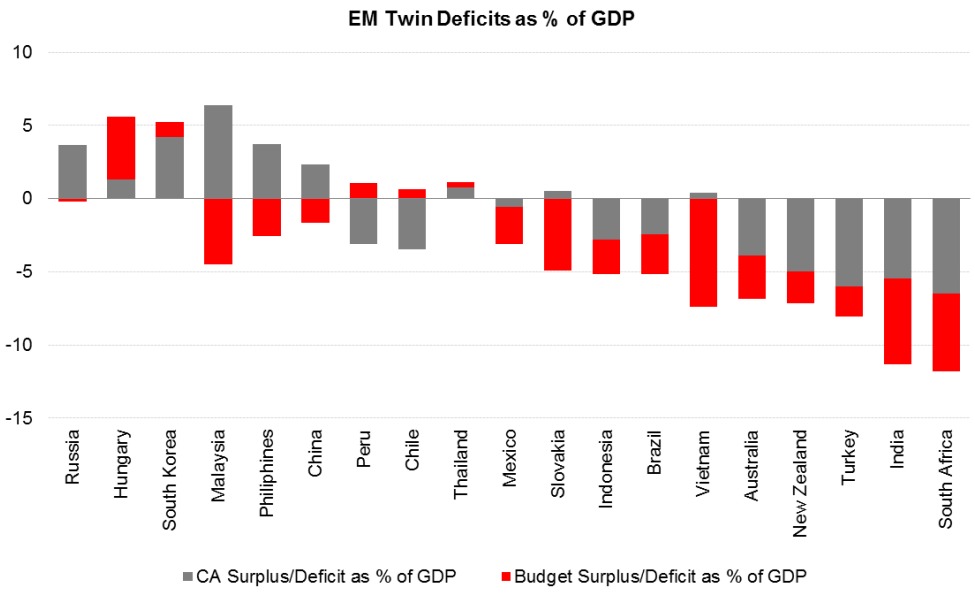


Source: MS

- **Twin deficits** of current account and associated budget deficits. We should be wary of blanket assumptions on deficit and surplus countries. Many with current account deficits have built up substantial reserves, **but they have experienced vast hot money flows which have underpinned domestic credit creation. Likewise some surplus economies like Korea still have significant dollar funding requirements.** Investment bank research only sees the large FX reserves, but ignore the domestic credit supported by foreign capital inflows.

Twin Deficit or Surplus as % of GDP (2012/2013)

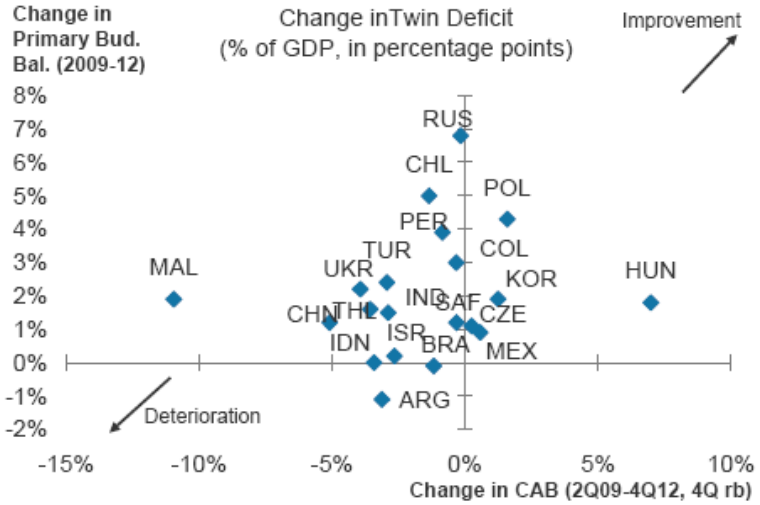




Source: Variant Perception

EM growth slow-down is leading to fiscal easing and widening of current accounts.

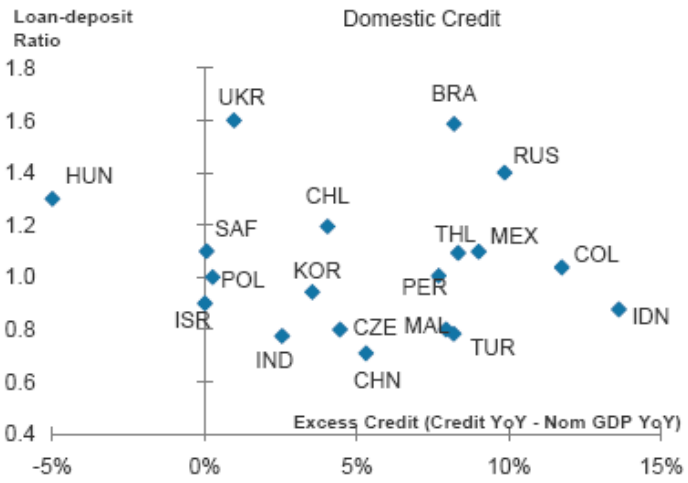
Fiscal Deficits Rising, Current Accounts Widening



Source: MS

- **Domestic credit** - as per our last point. If 'excessive' growth in credit has been fuelled by capital inflows then the likely misallocation of capital will eventually fail to produce the income to support such credit irrespective of whether or not the funding is withdrawn. It is clear that many EM countries, notably China are deriving no growth benefit from providing extra credit as it is merely supporting existing debt claims on moribund entities.

Credit Growth and Loan-to-Deposit Ratio *Still* High



Source:MS

- **Institutional framework**

Since the EM crises of the 80s and 90s there was a visceral desire for EM countries to build up FX reserves so they could avoid the 'patronising' hand of the IMF who many countries blamed for punitive bail-out terms. The growth of EM pension funds, as countries have liberalised their financial sectors and developed services for a growing middle class, now provide more of a back-stop to these markets. Recent EM tremors will test the structural viability of debt markets and the funds that could potentially support them.

Contagion

A study by Graciela Kaminsky called 'Crises and Sudden Stops' observed that sudden stops and contagion tend to occur in economies with financial fragility and current account problems. However her study revealed that due to high integration in international capital markets exposed countries to sudden stops even in the absence of domestic vulnerabilities.

In 1997 Asian crisis for example, none of the 'leading crisis indicators' highlighted above of financial vulnerability suggested Indonesia would have problems. Kaminsky explored the notion of 'contagion'. Eichengreen, Rose and Wyplosz (1996) defined contagion as a case of knowing that there is a crisis elsewhere increases the probability of a crisis at home, even when fundamentals have been properly taken into account.

Today flow has been driven by the very real desire for yield. This is very emotive driven which if participants sentiment shifts on the perception of risk reward then we can see a herding mentality across all countries where they have experienced such flows, irrespective of their fundamentals. The notion that a crisis in one country can spread to another and create a global financial crisis is also inherent in the third generation currency crisis models which emphasise how currency stress lead to financial crisis. With this in mind we turn our attention to 'hot' capital flows.

Hot Capital Flows

We really want to focus on the extent of hot flows, for although we agree that domestic debt and even short-term external debt exposure is far less than it was in the 90s we believe that cumulative foreign capital flows have supported high levels of domestic credit. Furthermore the rise in flows and credit has had a diminishing benefit on these countries output, which we believe leaves them more economically vulnerable to the loss of these flows.

Of course the build up of large FX reserves is a war chest but the demand for foreign currency and the need to replace domestic credit will lead to some uncomfortable decisions for central bankers and policymakers.

In 2009 once the system was seemingly 'backstopped', capital flew into emerging markets on the belief they had strong economic fundamentals driven by positive demographics and developing infrastructure needs. The real effective exchange rates of many of these countries have fallen as dollar funding dynamics led to a demand for dollars at the expense of most currencies in the world. The temptation of high yielding currencies at undervalued levels was too tempting for most investors. What we witnessed next was unprecedented, an excessive net cumulative foreign capital flows into emerging market countries (ex-China) which was twice that of the flow prior to the crisis (and that had been 'unprecedented' as a percentage of global GDP).

- Foreign capital flows into EM were $800bn 2000 to 2003
- $ 3.1 trillion inflows 2004 to 2007
- In 2008 flows collapsed (and we saw collapse in currencies as dollars were in shortage supply and lending had collapsed) only to recover with a vengeance as QE was implemented
- From 2009 to 2012 foreign capital inflows rose by $3.9 trillion
- Asia was the recipient of $2 trillion, LatAm $1 trillion and EMEA $650 bn
- In absolute dollar terms as % of GDP flows have been higher in the last 4 years than the previous but in nominal GDP (USD) terms they have been less as EM GDP has been growing
- Dollar issuances in EM countries exposes them to currency and maturity mismatch / liabilities
- USD strengthening exacerbates exposure and imposes restrictions on debtors to buy USD fuelling the imbalances of pegs further (they need to cover the dollar-denominated debt)

By definition some of these flows have manifested themselves in growing global international reserve assets. These have risen 67% from US$6.7 trillion to US$11.13 trillion, with leading EM countries, notably the BRICs seeing their reserves grow to US$2.766 trillion.

- Brazil's international reserves have doubled from about $190bn to $375bn in 4 years
- Mexico's reserves have grown from about $80bn to $168bn
- South Korean reserves have jumped from $212bn to $328bn
- Indonesia from $57bn to $105bn
- Russian reserves increased from $368bn to $480bn
- Turkey from $64bn to $109bn
- South African reserves rose from $30bn to $41bn
- Philippines reserves rose from US$35bn to $72bn
- Indonesia's has doubled to $105bn
- Thailand's jumped about 50% to $166bn

All this hot money flow has seen asset class capitalisation grow dramatically:

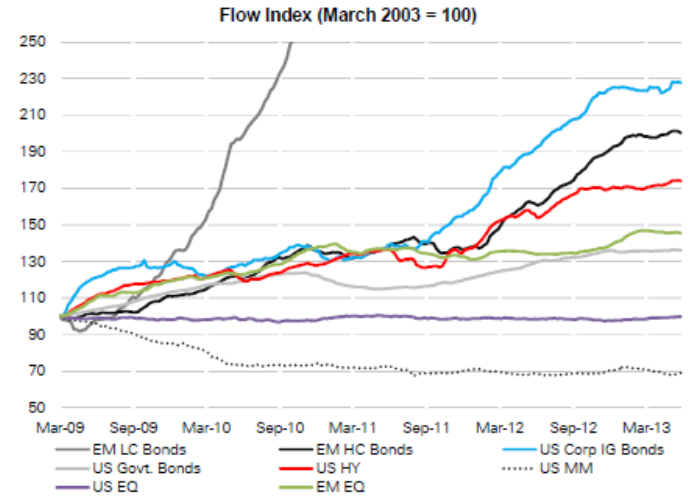
- Equity market capitalisation of the MSCI EM equity index has risen from US$570bn in early 2000 to US$3.7 trillion today
- EM sovereign debt market has grown from US$25bn to US$580bn; EM corporate debt from US$52bn to US$700bn, and EM local bonds up from US$250bn to $1.5 trillion
- EM local bonds have seen DM demand rise to US$400bn at a rate of $10bn a month since 2010. Brazil, Mexico, Turkey, Poland and South Africa have been the largest recipients

Emerging Market Capital Flow Composition

Since 2008 the main composition of capital flows into EMs (ex-China) has largely been driven by net portfolio investment. Bank lending and deposits have fallen substantially prior to the crisis, reflective of tight lending conditions in the rest of the world, primarily Europe.

Interestingly, while initial portfolio inflows post the crisis were more into equities, this then shifted more to investment in debt instruments as low bond yields in the developed world drove investors to chase for yield. We spoke at length on this in our HindeSight Letter March 2013 - Chasing the Dragon.

Beyond just the search for yield was the attraction of strong currency gains in surplus countries which had become undervalued after the crash and genuine concerns over fragile and indebted sovereign balance sheets in many developed markets. So you could even argue it was part and parcel of searching for 'safer homes' for capital.



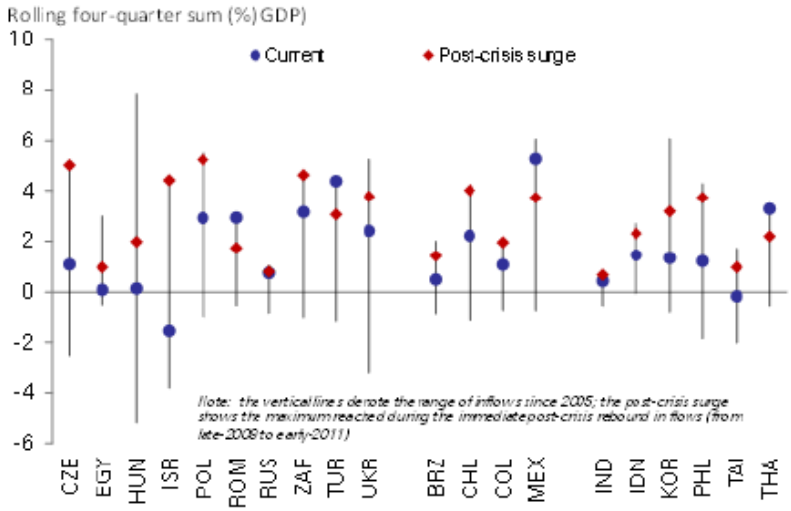
Note: EM LC flows is cut off from the chart for scaling purposes. The current index level is 432.
Source: Deutsche Bank

EM bond purchases were most notable in Mexico (3 - 6% of GDP). Turkish bonds reached 4.4% of GDP. SE Asia inflows are less easy to discern but they appear to be of the order of 1 to 2% in Indonesia, Korea and Philippines, and Thailand witnessed a record 3% of GDP. The growth of local bond markets, ie those denominated in the local currency rather than dollars has reduced the risk of currency mismatches, but has placed more of the burden on investors in the event of a depreciation of the local currency.

These inflows into local bond markets clearly create potential balance of payments vulnerability, especially if foreign investors decide or have to sell.

EM Credit Inflows

BRICs, like their developed market brethren, have benefited from Western QE, in so far as they imported de facto QE which drove hot flows and buoyed them with credit. This credit creation merely masked the structural deficiencies in their economies.



Although local debt markets may have grown, this does not mean they are any deeper in liquidity terms than they were in decades past. Indeed we would contend that leverage is running higher by dint of lower global real rates. These local bond markets are in their relative infancy and risk averse investors will be quick to sell. It's probably fair to say we can't be sure yet of the structural durability of these markets; besides which we know they have underpinned economic growth at a rate which is unsustainable, so any reversal of flows will just be self-reinforcing in contracting economic activity.

This is our BoP list, some of whom we will examine for signs of stress, which we believe portends continued stresses in the BWII make-up. **We will, just like in the real Top of the Pops, not reveal number 1 until the end!**

Top 10 BoPs

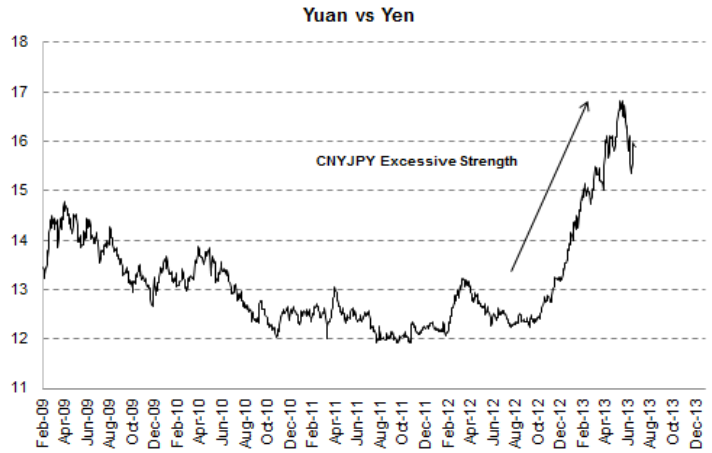
1. **???**
2. Brazil
3. South Africa
4. Turkey
5. Australia!
6. Ukraine
7. Indonesia
8. Thailand
9. Mexico
10. S Korea

Signs the Music are 'Sudden Stop'ping

It's not been easy to navigate the macro twist and turns these past years but our framework has been clear – either policymakers would succeed in arresting the credit bubble and create very high inflation or they would fail and we would be confronted with a resumption of the debt collapse. There will be no muddle through. The reality is that we have seen the invisible signs of inflation, and even more visible signs of asset inflation. Just imagine how low prices could have been without money printing. We have constantly been searching for signs of both of an uncontrolled crack up boom that Mises was so fond of expounding and also for those signs that the music would 'Sudden Stop', to use BoP crisis parlance, and unleash deflationary forces.

We have always maintained our view that global imbalances are central to understanding the continuing crisis, which is why he have spent so much time analysing trade and capital flows and their likely impact on asset classes. We wanted to share some of the signs that perhaps the music has stopped.

Abenomics 'reflation and reform' tactics have in our opinion triggered a major shift in global capital flows by undermining global trade flows. The rapidly depreciating yen against the dollar has put the holy trinity of dollar burden firmly on the Asian exporter pegs – ie China. This one chart is all you need to comprehend how damaging the yen move has been.



This has come at a time when China's economy has been failing to respond to the surge of credit expansion it undertook in 2012 and early 2013.

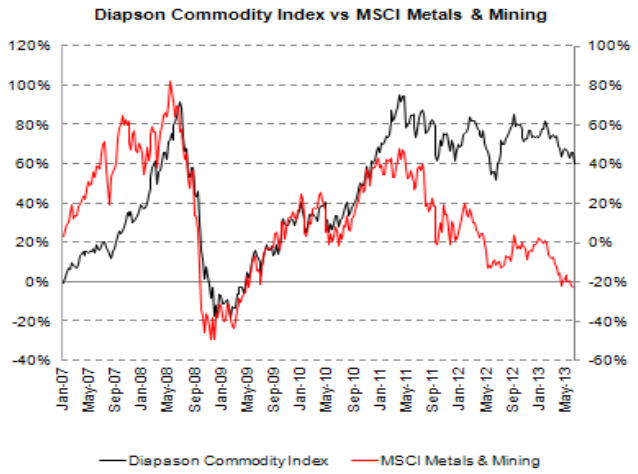
Commodity & Commodity Currency Signs

Ailing commodities, particular in base metals were clear signs that the China boom had reached overcapacity and investment had been misallocated to the sector.

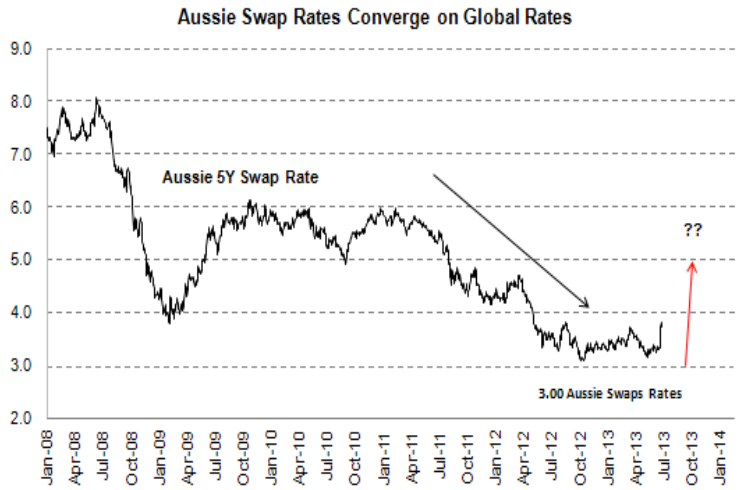
This would, in time, have severe ramifications for commodity export currencies, but although we had long since seen the signs of commodity decay over a year ago, the strength in commodity currencies had not unwound even in spite of falling interest rates. A Variant Perception piece Australia 'the Unlucky Country' outlined to clients the rationale of the vulnerability of Australia's growth bubble and the potential for a BoP crisis:

> *Australian growth dependent on two bubbles: domestic housing market and reliance on the Chinese fixed asset investment craze. Australia was suffering from Dutch Disease: resource sector boom crowds out manufacturing and industrial sector due to overvalued real exchange rate. Australia's net external debt level was horrendous despite large commodity exports. Large current account*

deficit and negative net international investment position, left banking sector vulnerable to capital flight. This would be bad for the Aussie currency. China slowdown was a greater risk to economy in eyes of the RBA than a housing correction. Australia was sitting on significant overcapacity in the mining sector which would be difficult to transfer to other sectors.



Australia's currency eventually became vulnerable when 5 year swap rates converged on the rest of the developed world the yield advantage they had maintained was gone. All those central banks and portfolio managers who sought diversification of reserve and risk assets are now left holding duration with growing capital losses both on principal and the currency.



Bloomberg News March to May:

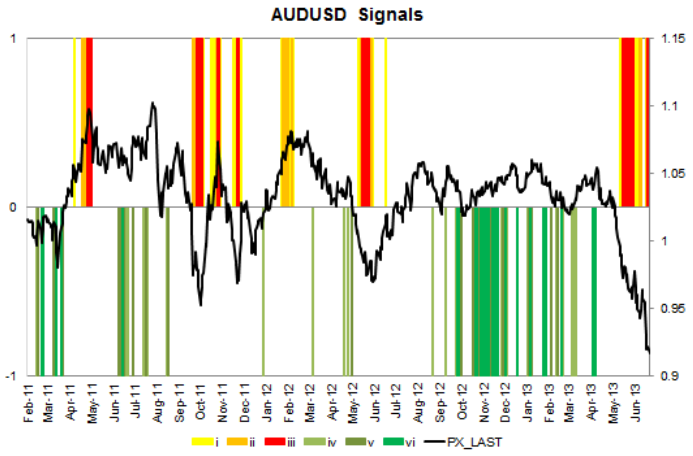
***Australia's building approvals fell, export prices weaker than expected* BBGNews**

- *Australia's building approvals fell 5.5% mom in March following a revised rise of 3.0% in February.*

Australia's construction sector shrinks for 35th consecutive month while trade balance came back in surplus; House price index rose

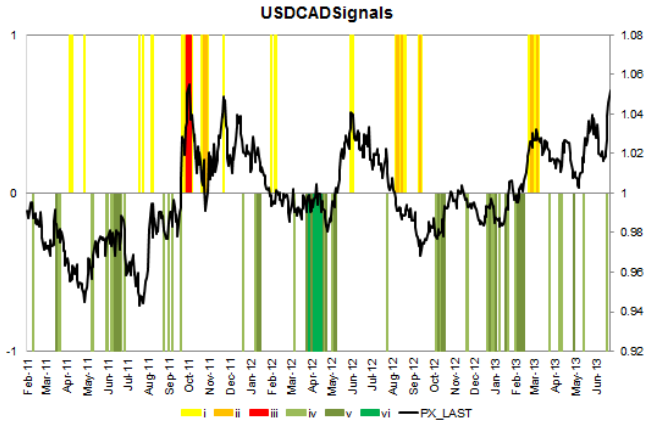
- *Australia's construction sector shrank for the 35th consecutive month in April, with a continued decline in home and apartment building as the AiG performance of construction index fell to 35.2 in April from 39 in March.*
- *Australia's trade balance came back in surplus of $307mn in March, with a median forecast of balance to be even in March and compared with a deficit of $111mn in February.*
- *Australia's house prices rose 0.1% qoq in 1Q compared to the revised rise of 2.0% in 4Q. In yoy terms it rose 2.6% in 1Q from a revised rise of 2.5% in 4Q but less than the 4.0% the market expected.*
- *Australia's central bank surprised the market by cutting the cash rate 25bps to 2.75%. AUDUSD fell 0.6% to 1.0183 in response. The statement introduced recognition of Australia's rising unemployment rate and seems to have left open scope for further cuts.*

Aussie Trend Ready Signals



Similarly the Canadian currency strength has been defying gravity, with its commodity export boom similarly over. Indeed one could say 'Loonie'. Its capital intensive tar sand oil reserves consigned to the waste bin for now as competition from US shale gas rises, perhaps the final nail in the coffin. As with the other commodity exporter countries, the housing boom that low rates and mining revenues have supported, is fast in reverse.

CAD Trend Ready Signals



China Credit Stress Signs

In 2005 China announced it would begin the much needed move to capital account liberalisation and a floating currency that this would entail. China moved to a managed peg against a basket of currency which brought in 'hot' money flows speculating on a strengthening currency.

Despite trade flows falling as China tried to transition from export and investment led growth to a balance of growth based on domestic consumption, the capital account growth spawned unhealthy credit creation across the finance sector.

It is the rebalancing of these trade flows that has unleashed the distortions created by the savings and investment dynamic of the capital account flows. China has witnessed an unbridled credit creation, exacerbated by these hot flows, which has supported activities that were not generating sufficient cash flow to repay their associated debt. Minsky and moment are two words that spring to mind. We will cover in our next HindeSight letter in more detail how the US/ China vendor-financing relationship will suck credit out the US system. The China current account is likely to be less in surplus, as it has come to light that there has been fraudulent reporting of export/import data and on the capital account side there seems to be a slowing in FDI and even capital account leakage. For now though we merely want to show the signs that the BWII unwinding is beginning in earnest from the Chinese end.

Bloomberg News: China names yuan convertibility plan as goal this year: Bloomberg

- *China will propose a detailed plan this year for allowing greater yuan capital-account convertibility as part of measures to loosen control over its currency and interest rates. The yuan plan will also include creating a mechanism that allows investments overseas by individuals.*

China banking system liquidity at reasonable level - PBoC

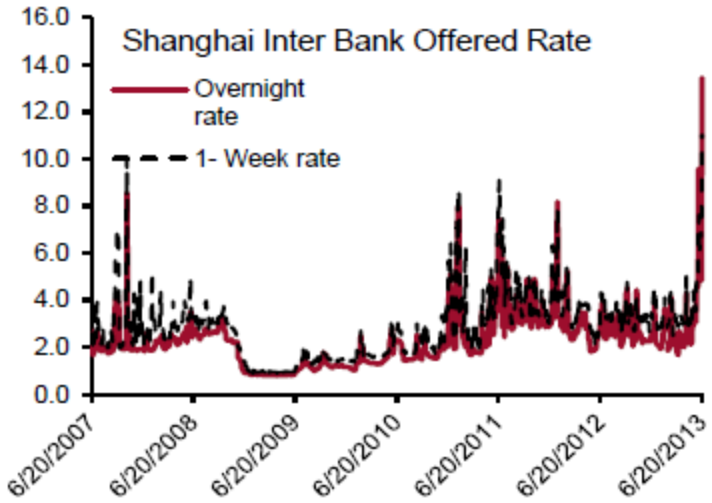
- *PBoC said in a statement today that China banking system liquidity is at a reasonable level and commercial banks must closely monitor market liquidity while keeping stable and appropriate credit growth.*

- *Xinhua, the official news agency, argued that while small and medium sized enterprises lacked money, the broad money supply M2 had still expanded by 15.8%yoy and total social financing aggregate continued to grow rapidly, with large enterprises having spent heavily on wealth management product. "It is not there is no money, but the money has been put in the wrong place,".*

In 2011 and 2012 China witnessed banking stresses as the authorities tried to rein in high inflation using macro-prudential regulatory tools and hiking reserve requirement ratios. This led to interbank lending rate spikes, but these were not of lasting duration. Today, we are witnessing renewed rate spikes but of a higher duration and magnitude.

The overnight SHIBOR rate jumped by almost 600bps to hit 13.4% on 20 June, its highest on record. The one-week rate also hit its historical high at 11.0%, after seeing a sharp increase of 292.9bps from its prior high of 8.08%.

Interbank Lending Issues – Shibor (CSuisse)



What is going on? The new Chinese leadership is embarking on reform of the banking and shadow financing sector. The leadership had to wait until the elections were done to pursue their ten year plan. Now they are embarking on real structural reforms. Premier Li sounds like Margaret Thatcher – a true free-market reformist. He talks like a (Peking) duck but will he walk like one? For now he is.

Bloomberg News: Chinese Premier Li Keqiang signaled reluctance to use stimulus:

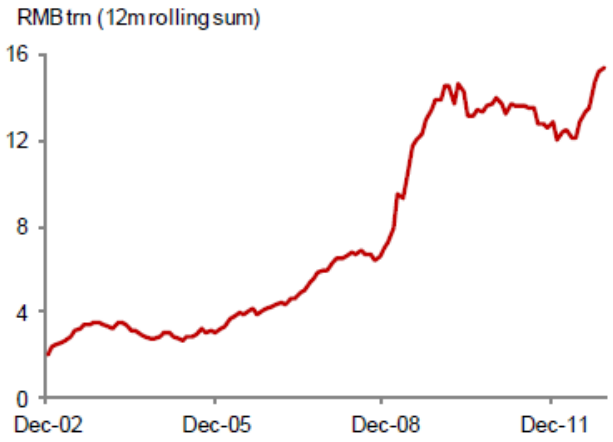
> *Premier Li Keqiang said that there is limited room for using stimulus and direct government investments to achieve China's development targets for this year, according to a transcript of a speech he delivered at a May 13 meeting that was posted to the Chinese central government's website. He also said that China has to depend on market mechanisms; over-reliance on government initiatives and policies for growth can't be sustained and may create new risks, according to Bloomberg.*

Bloomberg News: Li says China confronts 'huge challenges' as growth levels slow:

> *As per Bloomberg, Chinese Premier Li Keqiang said that China is confronted by "huge challenges" as it opens up the economy and that the new government's reform measures will be accompanied by tapered-off levels of growth. He further said that the Chinese government will move forward with market-oriented reforms to generate stable growth after the economy unexpectedly slowed in the first quarter.*

The PBOC and leadership have embarked on a serious game of brinkmanship with the social financing sector (credit) which has seen a Ponzi-like build up on loans between local governments, banks, trust companies funded by the selling of Wealth Management Products (WMP), effectively higher yielding deposit accounts for high net wealth individuals and a growing middle class. They wish to eradicate malpractice and malfeasance in lending by supplying liquidity to strategically or TBTF lenders.

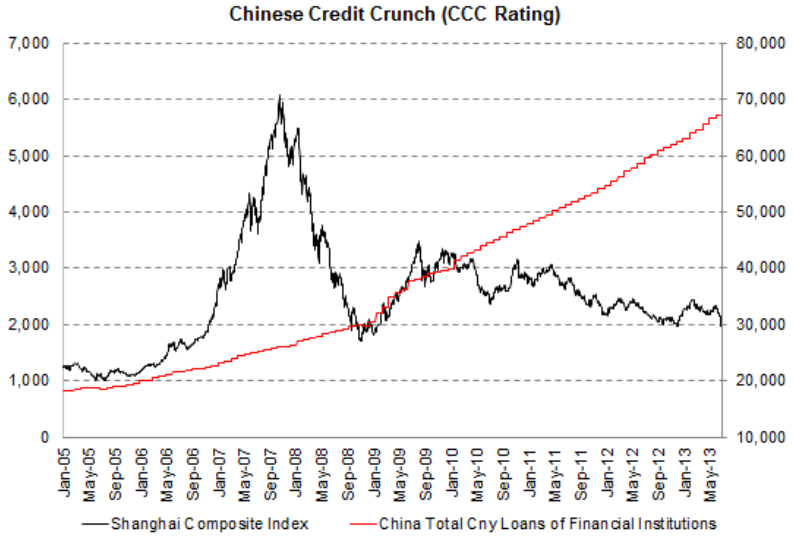
Credit Supply (Social Financing)



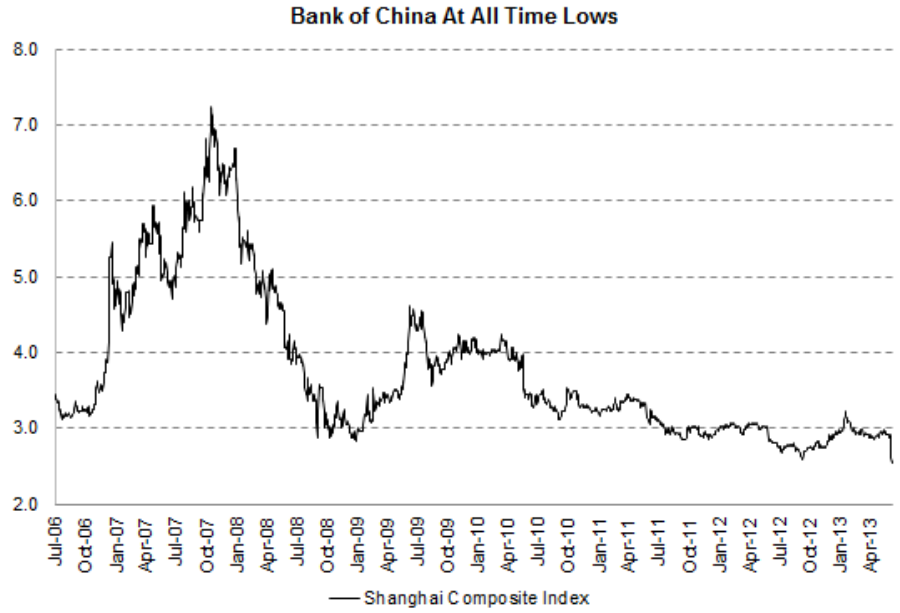
Source: Nomura

The risks of only providing targeted liquidity support for ailing banks and trust companies, is that the collapse in wholesale interbank liquidity could lead to a systemic crisis. The corporate lending market would dry up, local government repayment failure could rise and a retail bank run could occur as deposits are withdrawn. This is not a non-negligible risk.

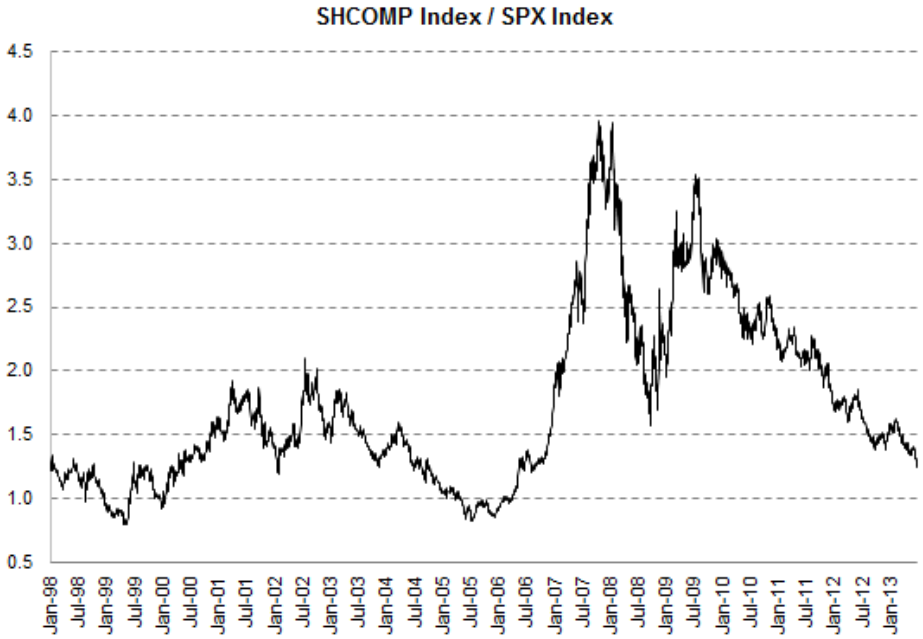
Chinese loan growth has been enormous but the stock market has continued to fall since the 2009 credit surge. This is a classic sign of capital misallocation. The corresponding revenue from entities supplied with these loans has not materialised, rather we suspect these loans have merely underpinned existing loan rescheduling and interest payments. Stock prices (revenue) have fallen in spite of the credit surge since 2009.



The largest Bank in China has taken out the 2008 crisis lows. Anybody care? An ominous sign of BoP issues to come for China.



The Shanghai stock index is doing a round trip versus S&P500 stock index. This all portends significant deflationary woes for the world.



Bloomberg News China's foreign direct investment dipped in April

- *China's actual FDI rose 0.4% yoy to USD 8.4bn in April, down from March's USD12.4 bn when there was a 5.7% yoy gain.*

If foreign capital flees China the BWII unravelling will only accelerate.

EM Signs

EM markets, most notably Brazil and South Africa, have been in a slow-burn negative balance of payment situation. This was a leading sign that BW II stresses would become more widespread.

Both propelled by commodity riches, these two countries have flattered to deceive. The 2008 crisis is succeeded in spurring a QE sponsored rally in commodities only to see a ramp up of mining expansion programmes, which had long not been needed. There was already too much supply for China to consume even before the crisis began.

Mega-mining mergers were a testimony of the hubris of mining CEOs who potentially had less of an eye on costs and more of an eye on global domination and their own purses.

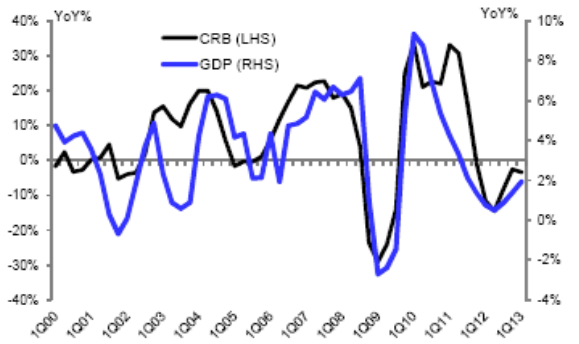
1. **Brazil a "Real" drop**

Brazil's Eike Batista, the commodity oligarch, featured on a two hour long program in the UK ,was feted to become the richest man in the world. He has become a symbol of the global commodity largesse. He is now rapidly selling off assets to pay back loans from his failing commodity and industrial enterprises.

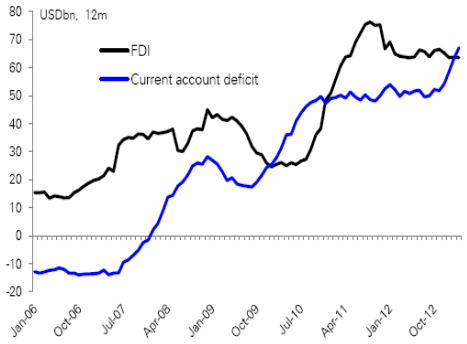
Brazil is experiencing a worsening current account deficit mainly due to export weakness as global imbalances are finally unwinding. Brazil has a low savings rate and hence is reliant on external savings (credit) to grow. Only but a few months ago Brazilian Finance Minister Mantega had implemented capital controls (taxes on inflows) to prevent 'overheating', now he is rapidly reversing barriers to flow and raising rates to fight outflows and rising inflation.

Fiscal spending continues unabated as there is a World Cup and Olympics to pay for and an election to be won. But voters can't be fooled. The wealth inequality has grown as corruption and plutocracy (still) runs rife. The resource boom created wealth for only a few but even that is evaporating now.

Brazilian GDP = Commodity Prices



FDI and Current Account



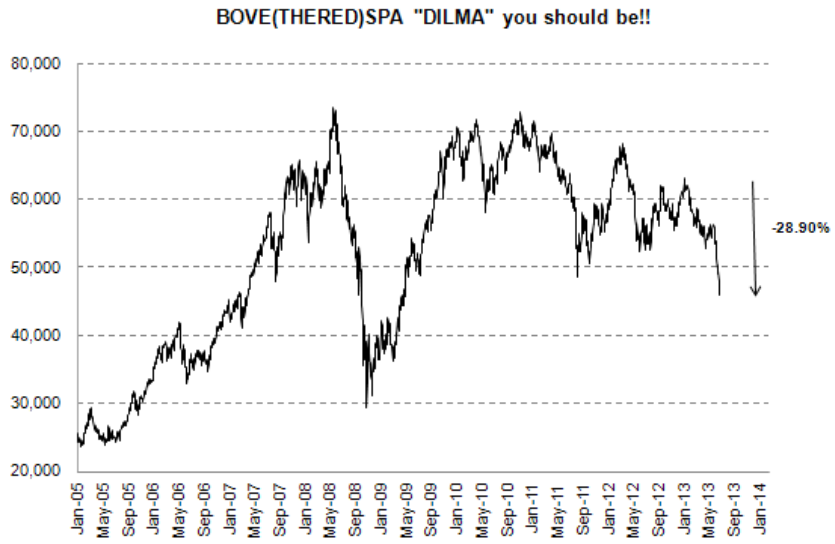
Source: Deutsche Bank

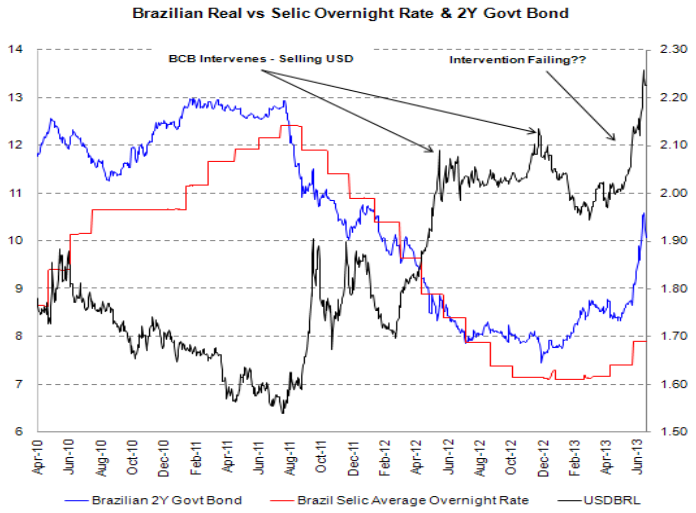
FDI will begin to slide as fears of deteriorating economic conditions and age old populist unrest rears its Latino head. Nothing scares away investment faster. The "Tropical Spring", as it is being dubbed has seen more than one million Brazilians in over 100 cities take to the streets to protest against growing corruption and price hikes.



Source: LatAmBlog

Domestic credit in Brazil has been aggressively supported by the state. The government has been using its banks to provide highly subsidized credit to the private sector, not only the BNDES, but also to the retail banks Banco da Brazil and Caixa Economica Federal. The BNDES and public banks owe the government nearly 10% of GDP. Dilma seems unfazed but the Bovespa seems really bothered.





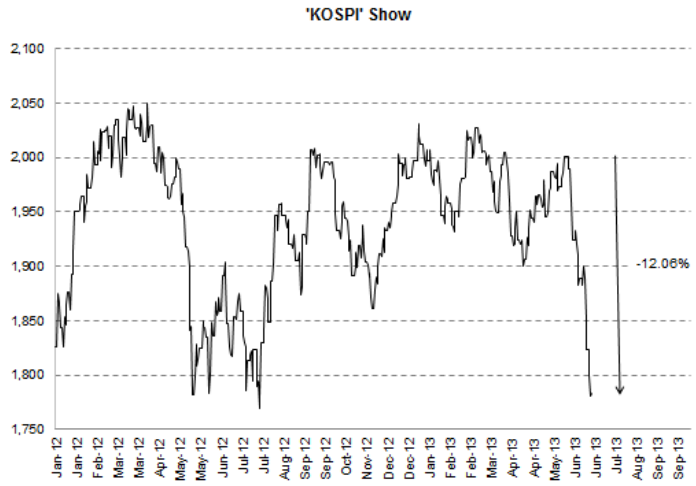
Bloomberg News: Brazil: IOF Tax Cut

- *Finance Minister Mantega announced yesterday that the government would remove the 6% IOF tax on non-resident investments in fixed income securities. The tax had been introduced in 2011 to reduce downside pressure on USDBRL. Recent ongoing weakness in the Real, in spite of a larger-than-expected rate hike last week, was quoted as one reason behind the decision to unwind the measure. However, the IOF tax on derivatives has not been removed.*

The Brazilian central bank (BCB) has been intervening aggressively in the currency. According to Morgan Stanley, the BCB sold 877 million USD swaps on one Friday alone. Brazil has the FX reserves to play this game a while yet though. Their real problem is inflation and if the BRL weakens too much it will stoke inflation pressures again prompting the central bank to administer pain through hikes. Essentially, Brazil badly needs some kind of take-up of demand in China, and there is fat chance of this happening.

2. South Korean "Kospi" show

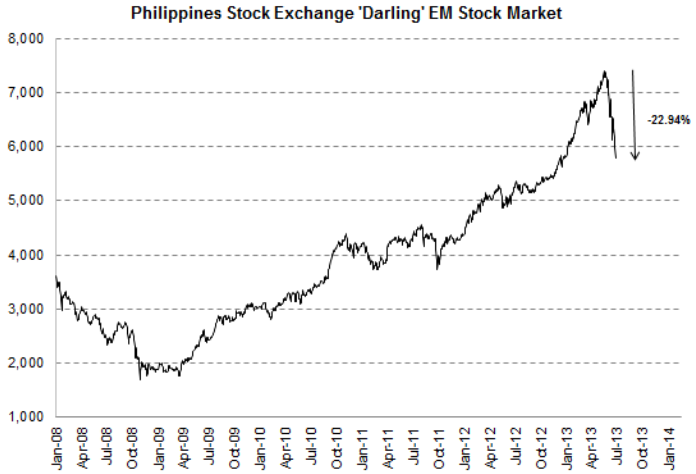
Korea is showing growing deflationary issues?



3. Philippine Problems

Bloomberg News: Philippines March imports saw steepest fall since April 2012

- *The Philippines' imports fell 8.4%yoy in March compared to the fall of 5.8% in February, the steepest decline since April 2012. However, the value of total monthly imports was $4,922.1mn in March, a three month high from the previous reading of $4,708.0mn in February. The Philippine's trade deficit reduced to $593mn in March compared to the previous $967mn deficit in February.*



4. Stuffed on 'Turkish Delight'

On May 31st anti-government riots sprung up in a challenge to PM Erdogan's 10 year rule. He has ruled more in the fashion of a benign dictatorship rather than as a leader of democracy; his increasing autocracy has finally broken the patience of a young middle class.

Sultan or Democratic Leader



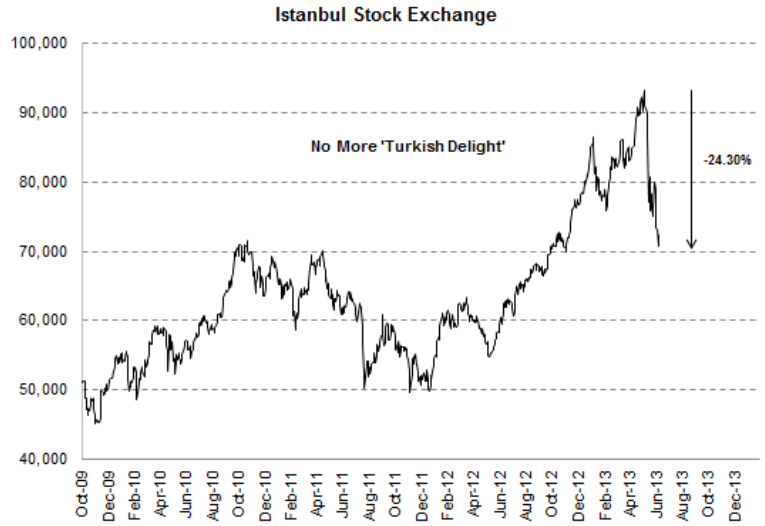
Source: Economist

We suspect Turkey was a major trigger in forcing investors to reappraise their EM positions globally. The wave of global unrest is symptomatic of widening wealth inequalities brought about by misguided monetary policy. Plutocracy seems an apt word to describe the rule of law in most countries and it is the accumulation of power and wealth amongst a few that is creating a backlash.

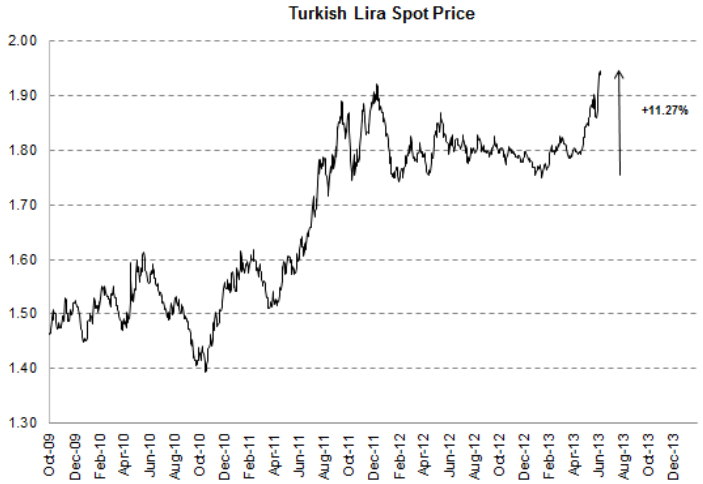
You can't make this up. Just as rioting breaks out, one of the rating agencies upgrades Turkey.

Bloomberg News: Turkey – Moody's Rating Upgrade

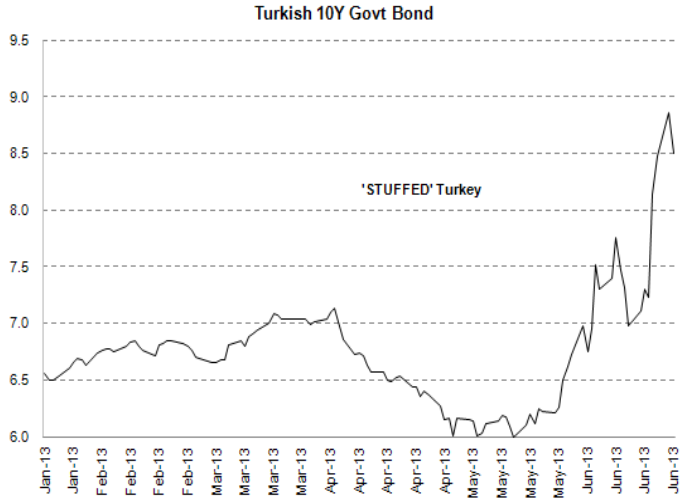
- Moody's upgraded Turkey's foreign currency long-term credit rating to Baa3, in line with Fitch at BBB- and above S&P at BB+. The upgrade has been part of consensus expectations for an extended period and was one of the main drivers of real money demand for Turkish bonds in the past 12 months. The announcement follows a sharp one-day decline in TRY, triggered by the central bank's 50 bp cut in all three main rates, while markets were expecting a 25 bp cut.



The Turkish stock market has fallen over 24% in lira terms, while the lira has fallen over 11%. So imagine the size of the fall in dollar terms – yes 24 + 11 = 35%.



Stuffed full of Turkey bonds investors are now bailing. These bond yields may bring new meaning to 'what a turkey.'



5. Thai Re-Baht-all

Bank of Thailand considers measures to *re-butt* fund inflows – *Bangkok Post*

- According to the *Bangkok Post*, the finance minister told the press yesterday that Bank of Thailand (BoT) is considering imposing a minimum holding period for foreign investors buying Thai bonds and charging a fee for investment in debt markets. However, he also said that no specific timetable for implementation had been set. The plan was submitted to the finance ministry last week.

Bloomberg News: Thailand's GDP weaker than expected, raising risks of BoT cuts

- *Thailand's GDP rose 5.3%yoy in 1Q, less than the market expectation of 6.0%. On a quarterly basis, GDP contracted 2.2% (sa) in 1Q compared to the -1.5%qoq consensus. 4Q growth was revised lower to 2.8% qoq from 3.6%qoq previously.*
- *Thailand's National Economic and Social Development Board (NESDB) revised its GDP growth target to 4.2%-5.2% from 4.5%-5.5% after today's GDP release. The NESDB's secretary said monetary policy is the fastest measure to combat inflows, and if monetary policy isn't enough, tax measures can also be used.*
- *The weak GDP outcome today is likely to put additional pressure on BoT to cut rates at its 29 May policy meeting. Rate cuts are likely to be supplemented by FX intervention to guard against THB appreciation, in our view. We continue to project a gradual rise in USDTHB towards 30.5 in 12 months.*

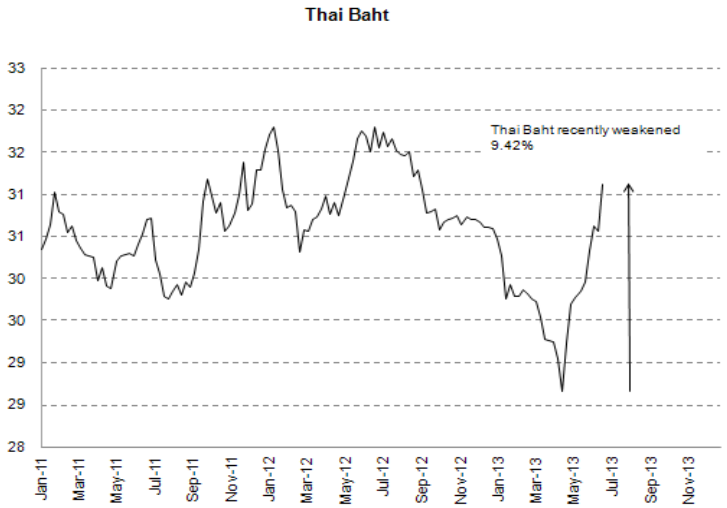
Bank of Thailand Governor turns dovish, shifts rhetoric toward cuts

Bank of Thailand Governor Prasarn Trairatvorakul told reporters today that Thai economic growth has begun to cool and that "balance of risk may be tilted to another side." He also noted that interest rate differentials were one factor driving inflows contributing to THB strength. These comments potentially signal that the BoT is considering cutting rates in their May 29th policy meeting.

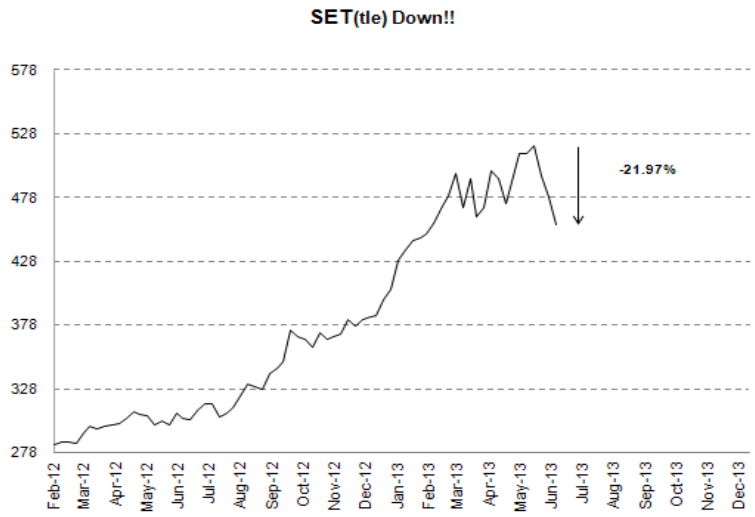
Thailand to impose measures to weaken the THB

- Thailand's Finance Minister and Deputy Prime Minister Kittiratt Na-Ranong will impose some measures suggested by the central bank to weaken the baht, the Bangkok Post reports without saying where they got the information.
- Yesterday Kitiratt told Cabinet that the central bank has submitted a plan to amend laws to allow implementation of two out of four measures proposed, according to news reports.

So in one breath the BoT Governor sums up the negative consequences of global QE. Capital inflows have supplied these EM economies with too much credit and at the same time driven real effective exchange rates so high that they have to actively discourage the flows at a time that growth is beginning to turn due to a lack of export competitiveness.



The Stock Exchange of Thailand (SET) begins to settle down. Signs of BoP crisis?



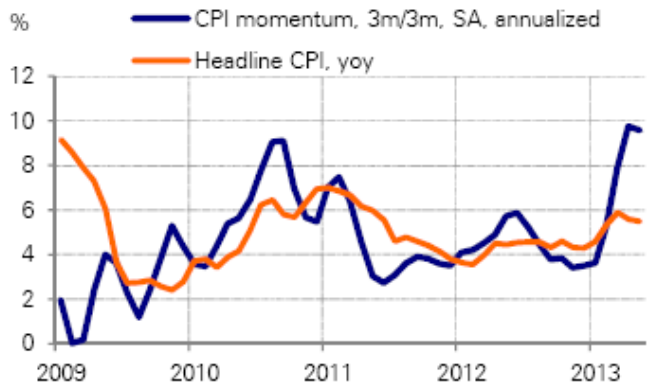
We remain bearish the THB. At current USDTHB levels, the risk of capital control has moderated significantly, but fixed income investors are likely to remain cautious. The current account is likely to deteriorate to a deficit towards the end of Q4, leaving THB vulnerable to outflows.

6. Indonesian Interference

Bloomberg News: Indonesia raises subsidized fuel price

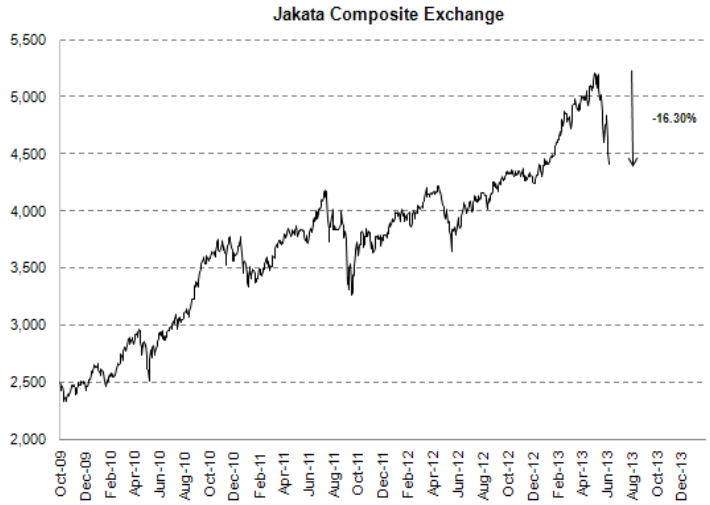
- Indonesia announced hikes in subsidized fuel prices. The price of subsidized gasoline was increased by 44% to 6500 rupiah a liter, and diesel by 22% to 5500 rupiah a litre, in line with previous comments from the government and market expectation.

Indonesian CPI – An Auspicious time to hike fuel prices

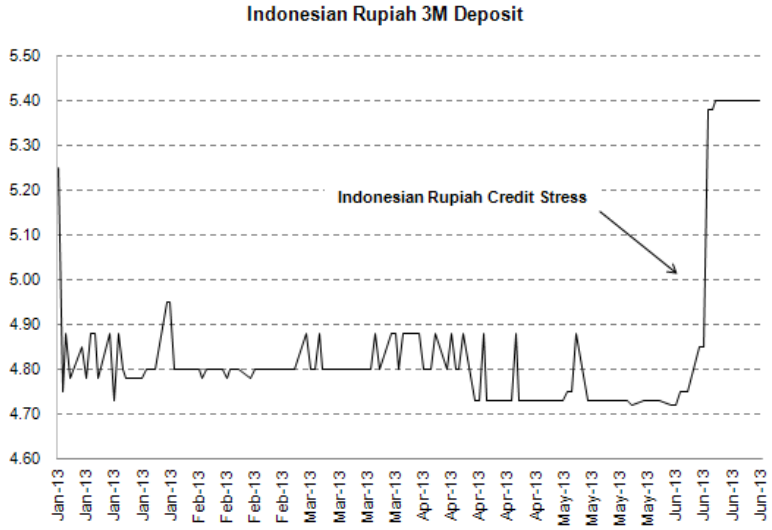


Source: Deutsche Bank

Removal of fuel subsidies will be a good thing in time but these hikes will cause inflation to rise. Fuel demand is likely inelastic in Indonesia, and with the country is experiencing a widening current account deficit, pressure will come to bear on the currency (rupiah) and stock market.

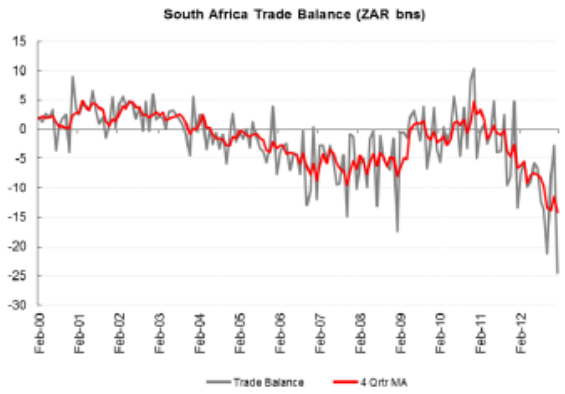


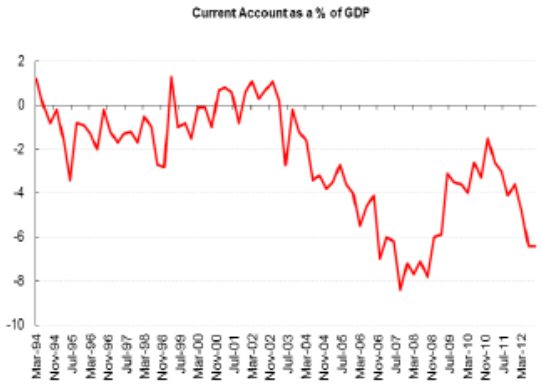
Signs of credit stress?

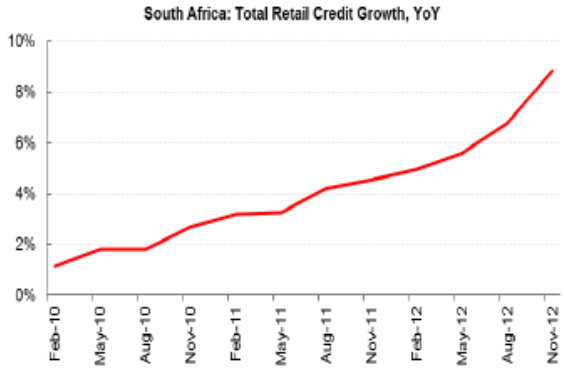


7. ZARo Value - South Africa

South Africa is a shoe-in for a current account crisis. Falling terms of trade, consumption driven by credit which is funded by external debt and its not a wonder the ZAR has been falling.

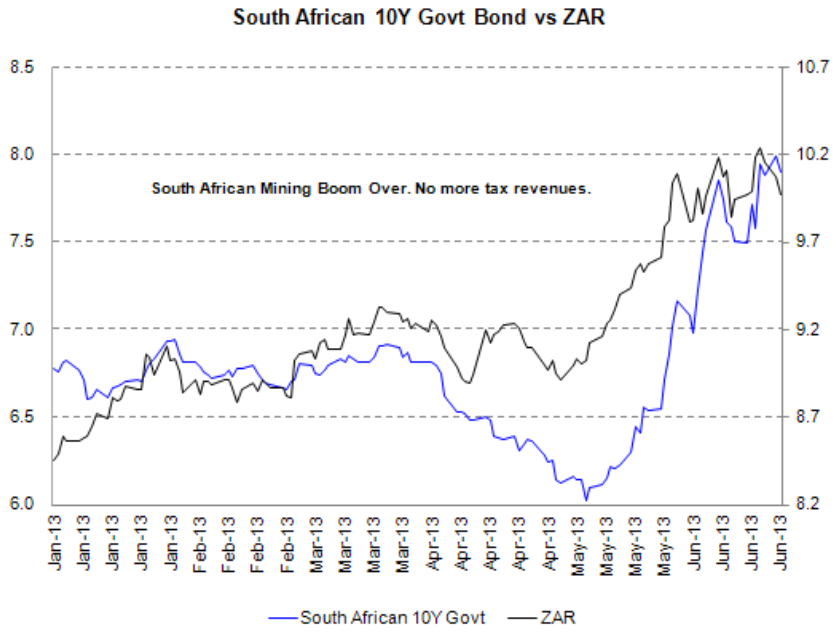




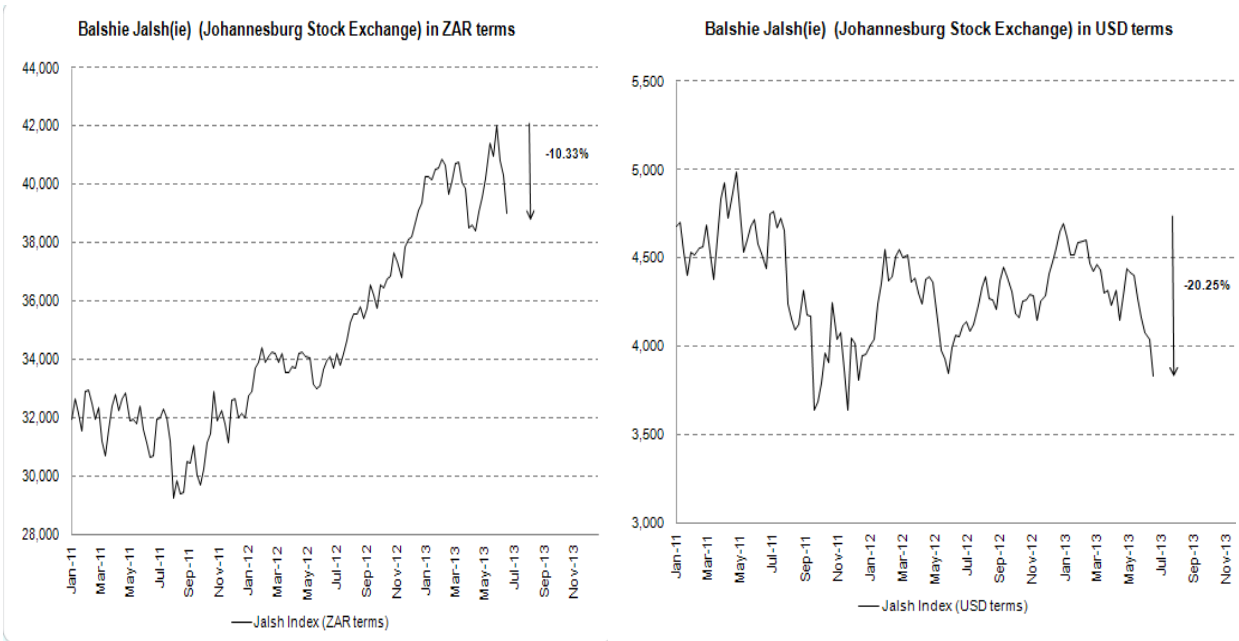


Source: Variant Perception

ZAR is falling and the bond market is collapsing.



The Jalsh (South African Stock market) is down only 10% in ZAR terms whilst in dollars its down over 20%. Clearly the ZAR has depreciated 10%. It's amazing what currency debasement can do to nominal prices. Optically the Jalsh looks like it hasn't gone down much but in real terms it actually has. US investors may ponder the true value of the S&P500, based on this observation of nominal versus real values.

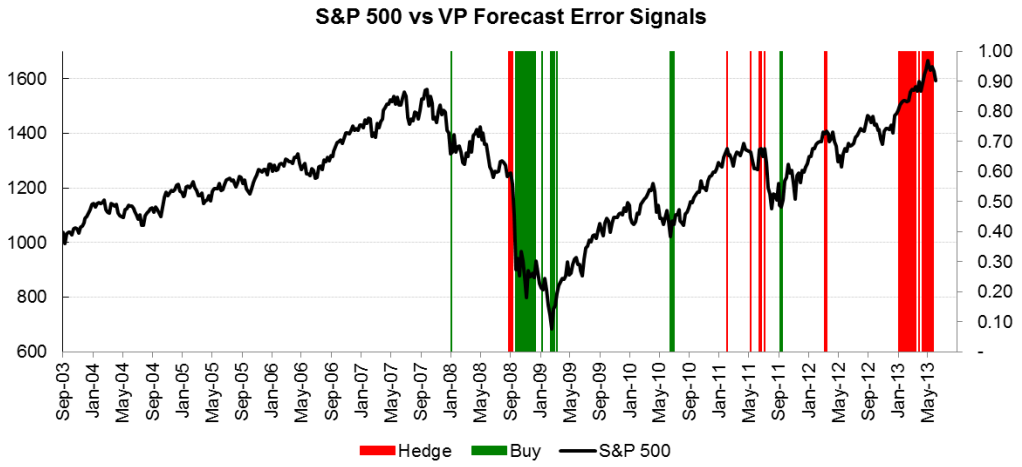


We could talk ad nauseam about India, Ukraine, Mexico and a host of other BoP candidates but we think you get the point. The signals that the music will stop are there.

Equity versus Economic Signs

Equities have been running ahead of economic fundamentals for a substantial time. All the models we look at currently would suggest that equities offer a very poor outlook. In the context of the substantial bond sell-off, this must be rather disheartening news for equity investors.

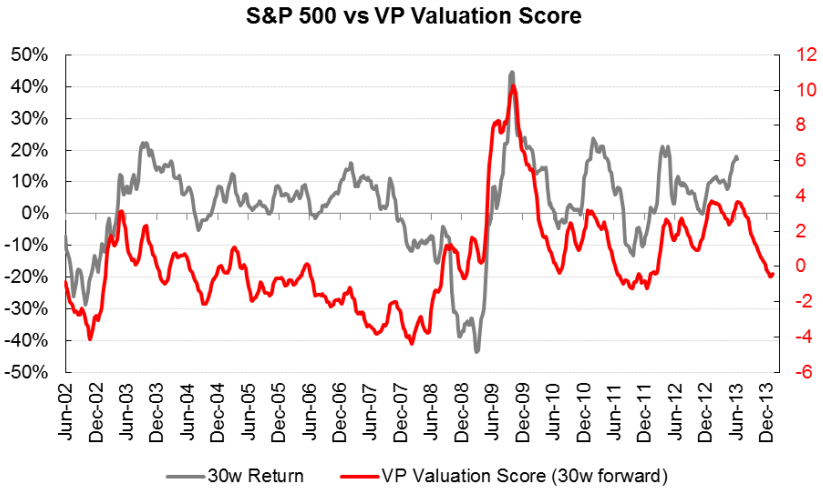
The chart below plots the S&P 500 against periods of overvaluation measured as the S&P 500's performance relative to its net speculative positioning, its own past performance and chemicals prices.



Source: Variant Perception

The market has only recently started to correct to its fundamental value and, given the extended period of overvaluation, it may undershoot its fair value substantially.

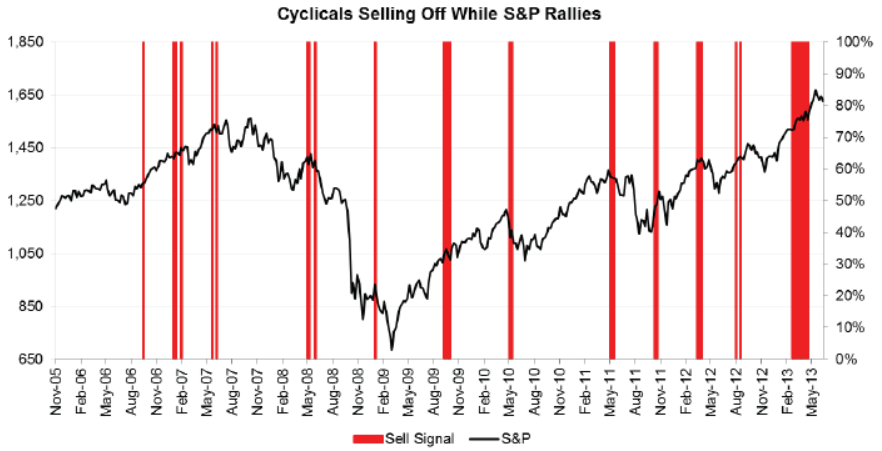
Another way to look at the valuation of equities relative to fundamentals is to look at the following chart plotting our sister company Variant Perception's proprietary forward-looking valuation score versus the US stock market.



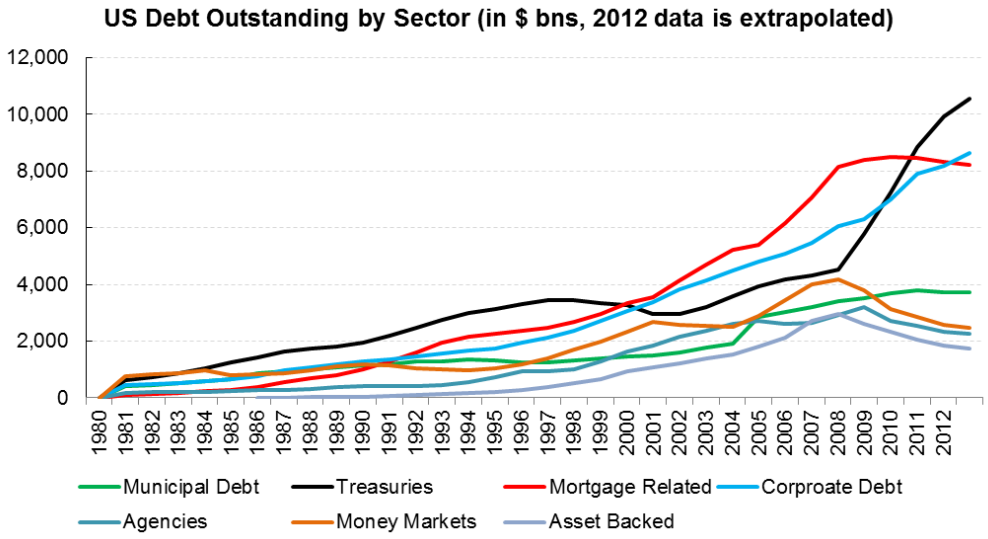
Source: Variant Perception

In many ways the US equity rise had some logic to it as seemingly, yields were too low, there were signs of housing revival, and commodity falls led to an almost 'goldilocks' feeling amongst investors. There were almost hints of desperation as investors dumped safe-haven assets for fear of missing out on an economic revival.

Oddly cyclical equity performance has not been reflective of the growing sense of demand, although we would caveat that there are positives - US earnings growth has rebalanced away from the bubble sectors; but new sectors have seemingly risen on a sea of corporate debt issuance and buybacks. Note the light blue line of corporate debt outstanding in the second graph.

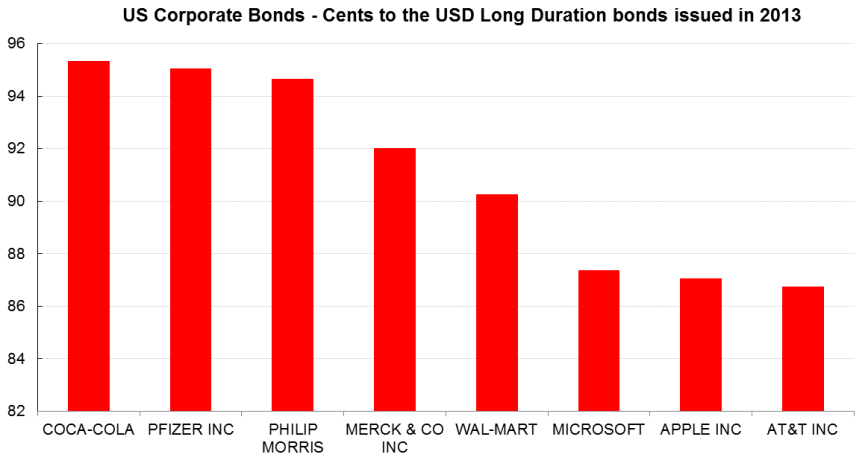


Source: Variant Perception



Source: Variant Perception

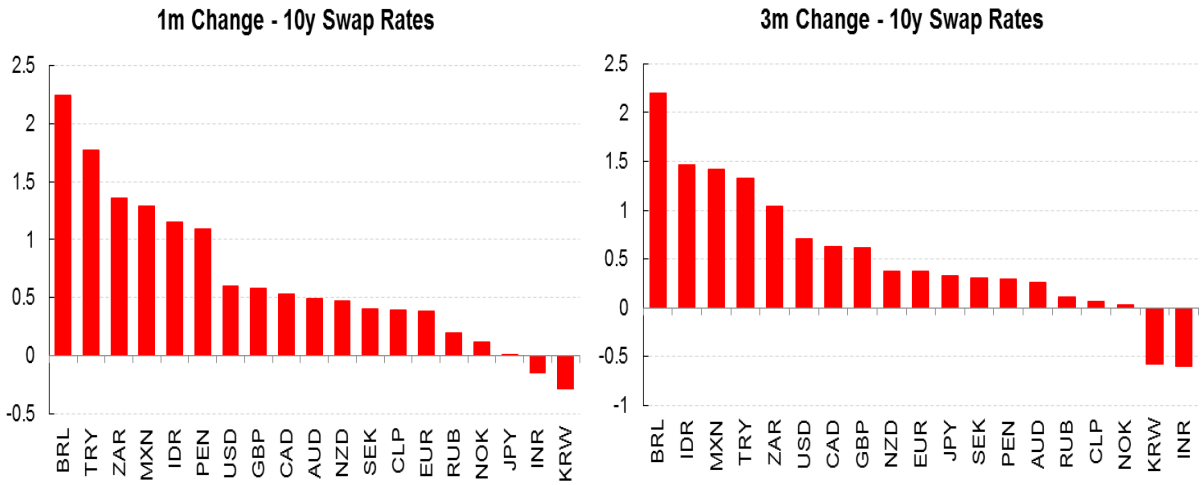
Rotten 'Apple' bonds are almost at the bottom of the 'safe haven' blue chip bond barrel. Well, of those issued most recently. Apples recent issuance to pay for 'taxes', sorry 'research and development', were another sign of over-reach on low yielding bonds. Investors have once again foregone any credit prudence even on blue chips.



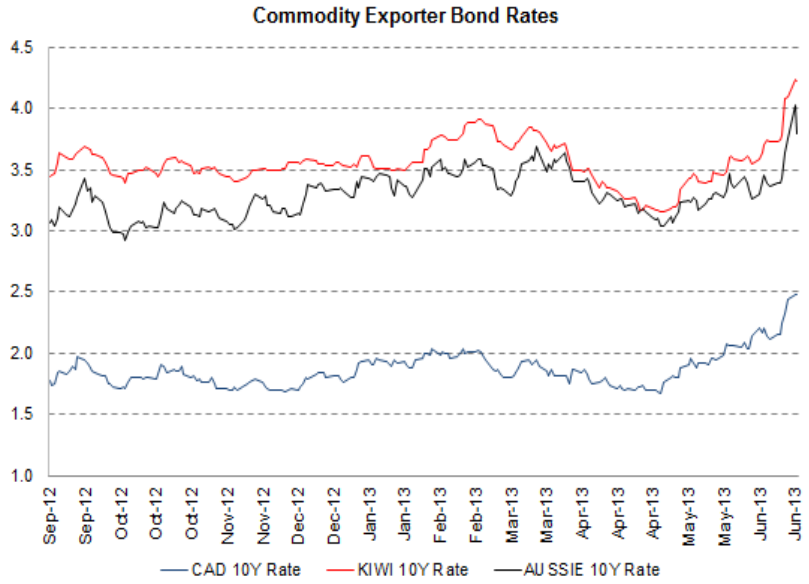
Source: Variant Perception

Debt Bubble Pricked?

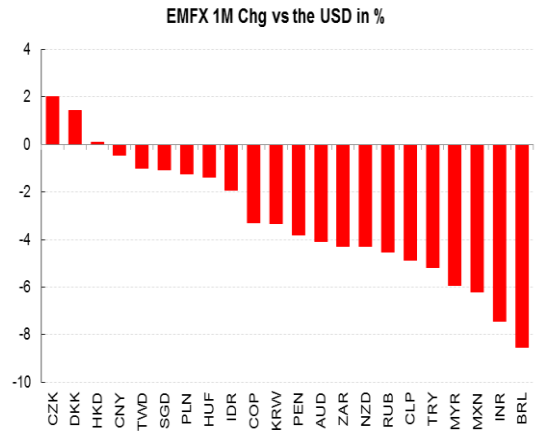
The Global Debt Bubble is bursting as BW II imbalances continue to unravel. We must look to front end rates and interbank rates for signs of more stress and a lack of liquidity. If we see rates rising in spite of lower interest rate forward guidance by central banks then debt deflation and asset depreciation will send shock waves around a withering global economy.

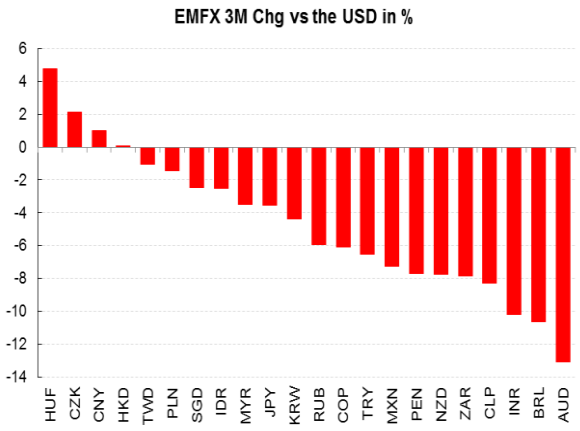


Commodity exporter nations long end rates are rising rapidly at time their economies can least afford it.

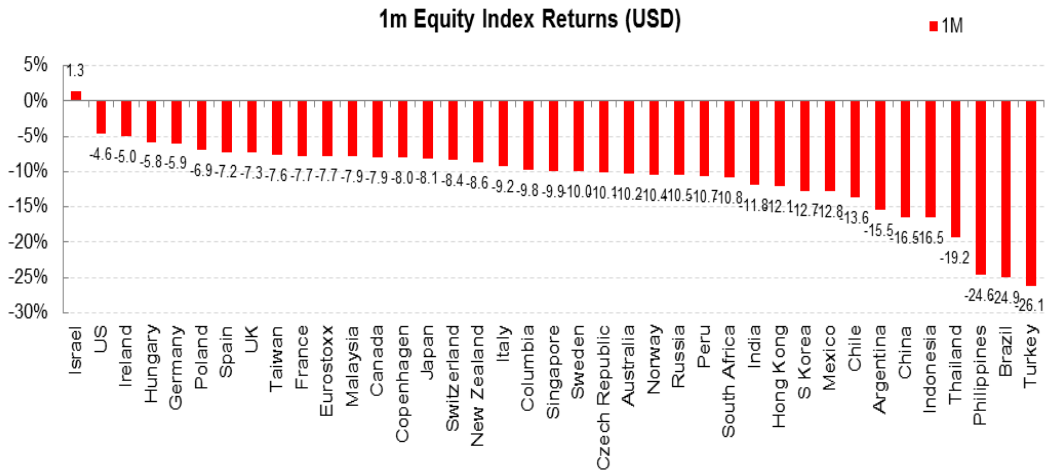


Bond exodus from EMs leads to demand for dollars of foreign currency versus their own.

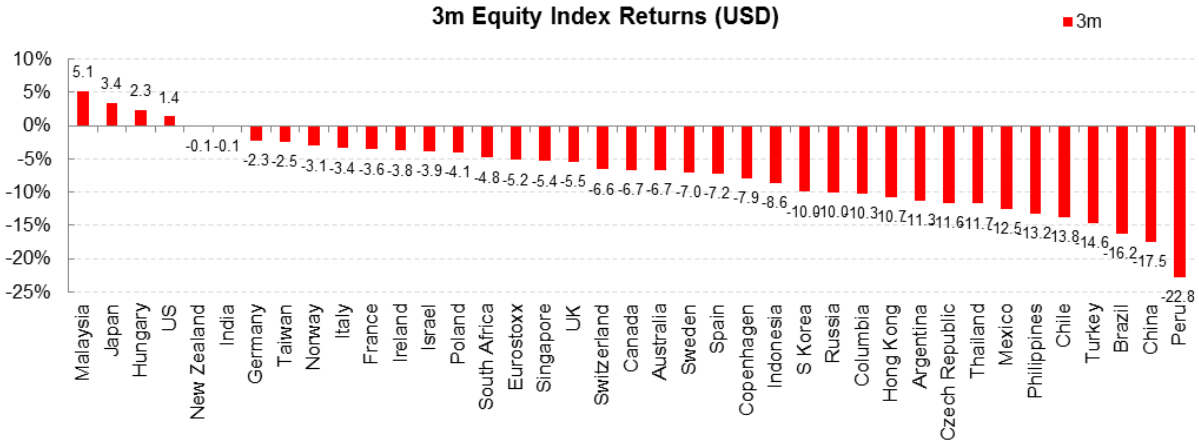




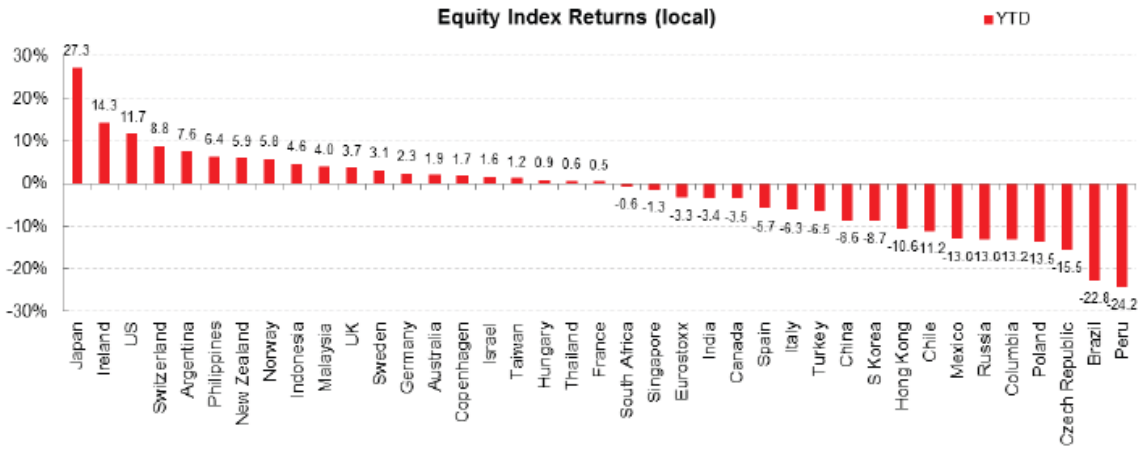
Equity Returns 1 month and 3 months.



Source: Variant Perception



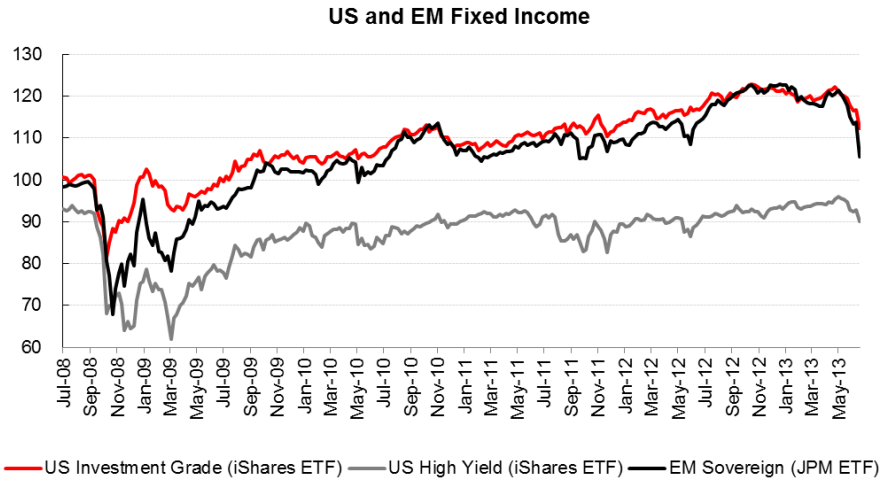
And year to date.

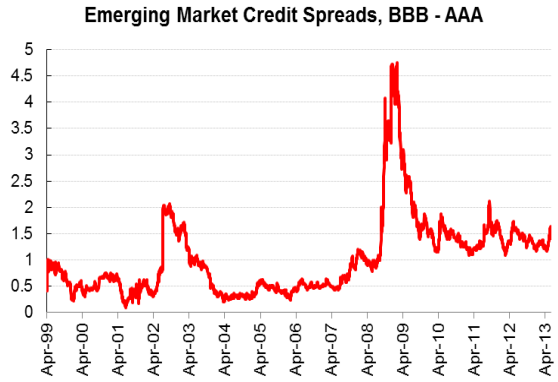


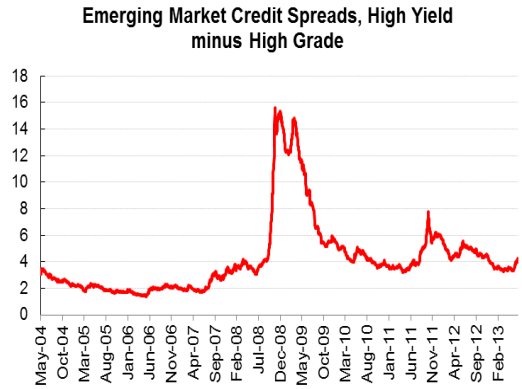
EM equities – Falling BRIC.

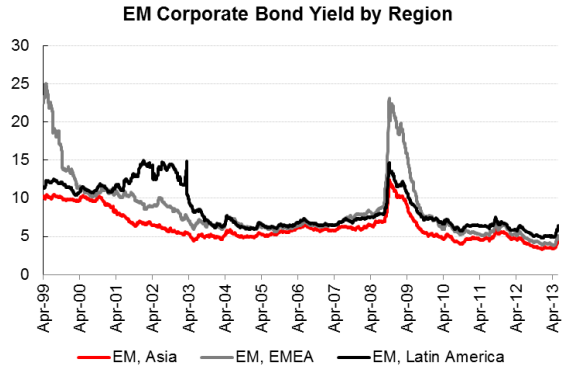


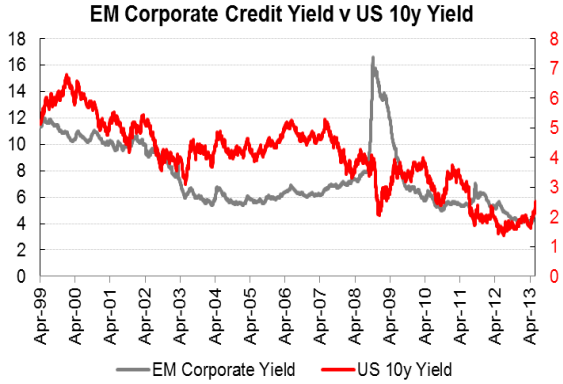
Global QE has driven the risk reward across the credit spectrum to absurd levels. There is a long way to fall for overpriced bonds. Rwanda, Apple, and other issuers must be laughing at the stupidity of investors.











Source: Variant Perception

The Final Outcome?

US 30 year bond yields going higher….



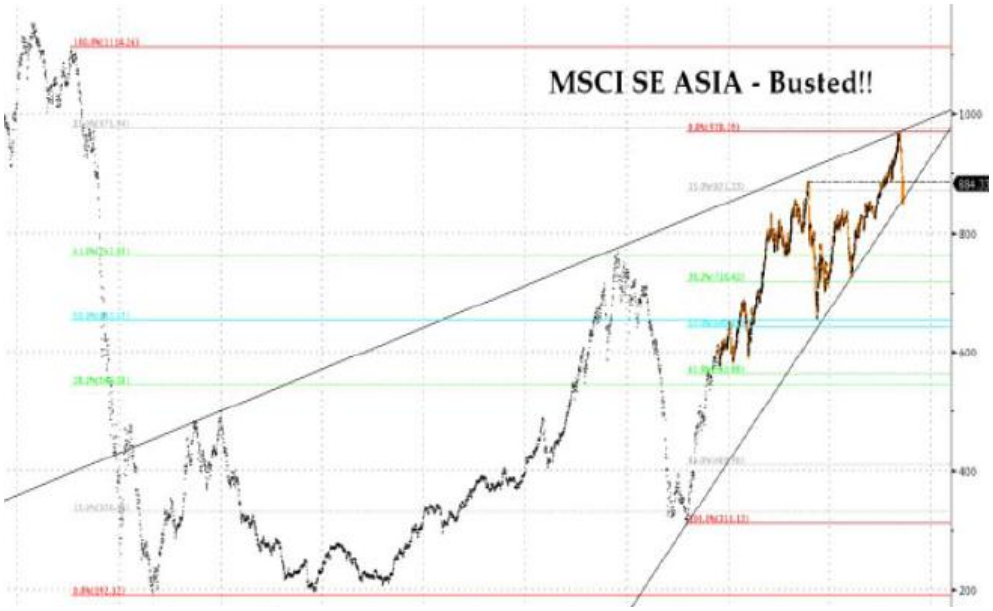
Source: Sean Corrigan, Diapason Commodities

….EM yields will follow as trade flows fall and offsetting capital flows will not be forthcoming from overinvested foreign portfolio investments.



Source: Sean Corrigan, Diapason Commodities

Higher EM yields spells only one thing lower MSCI SE Asia stocks, as the exodus of foreign capital that supported excessive credit growth continues.



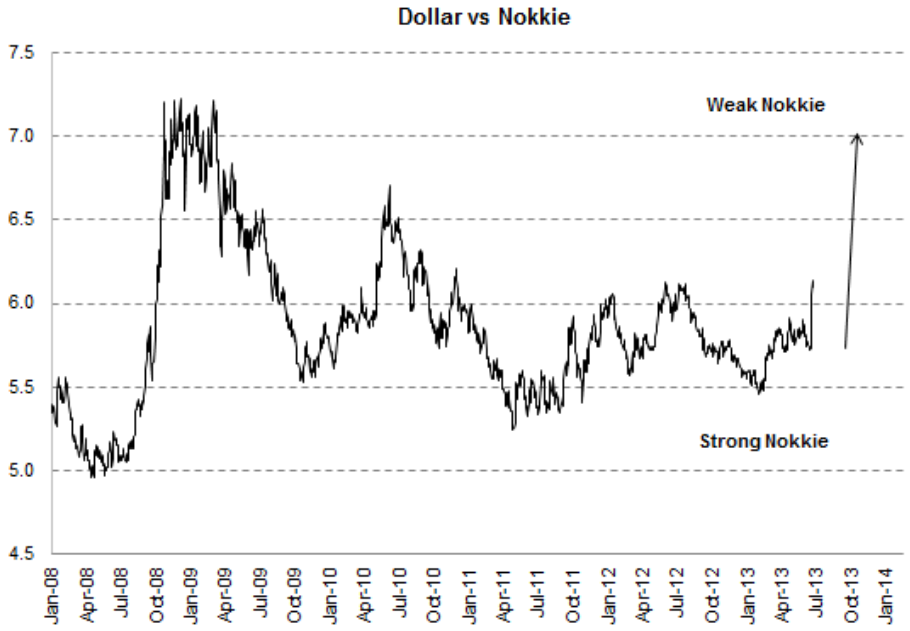
Source: Sean Corrigan, Diapason Commodities

Oil is too expensive, world growth is slowing. The WTI curve is in backwardation with record longs and record inventories. What gives? Fears of ME escalation and NATO involvement or existing bottlenecks elsewhere in the OTC markets? No matter what the reason oil is 'trend ready'. If it breaks higher then EM markets who are major importers of fuel will get smoked.



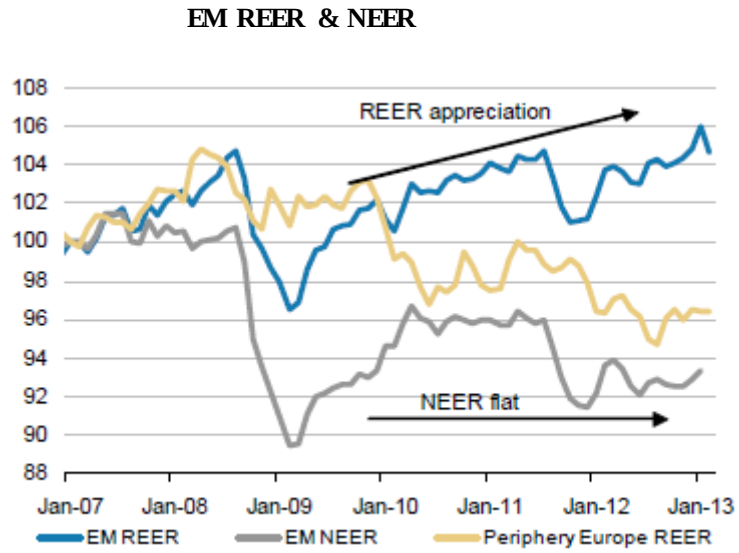
Source: Sean Corrigan, Diapason Commodities

Even the inveterate NoKKie has shown signs of giving up the ghost after years of strength. The Norges bank hinted at rate cuts, and what with increased government spending a head of elections the once invincible Nokkie has lost its safe haven yield.



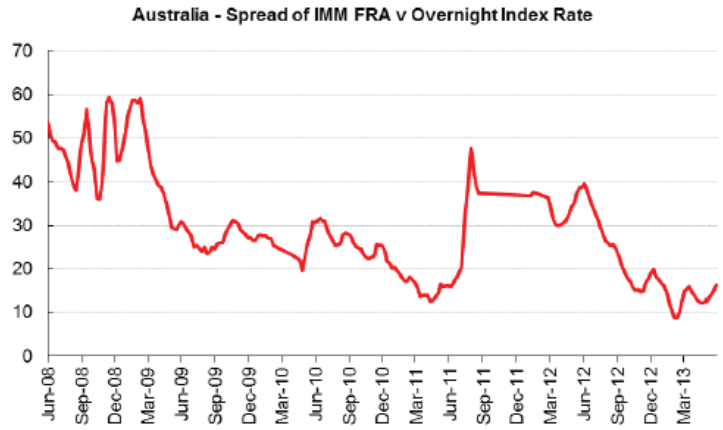
Source: Sean Corrigan, Diapason Commodities

EM REERs are not cheap.



Source: Morgan Stanley

Watch for eurozone periphery style inversion in Australia and look for signs of interbank stress. Short rates are still well-anchored in Australia which signifies that funding conditions are still benign. This could change, however, over the summer if the Chinese credit crunch persists. Australia is one of the main candidates for a banking and corporate funding crisis in our view. Banks and corporates have substantial exposure to the offshore markets and this makes them vulnerable to an international squeeze in liquidity. This would likely materialise in a bear flattening (inversion) of the yield curve and potential liquidity operations by the RBA (currency negative).



Source: Variant Perception

Conclusion

The purpose of this HindeSight letter was to remind us all that the global economy should be thought of as a system where every country and its policies have a direct or indirect impact on other countries through the capital and current account. Since we left the restraint of the gold standard (see Appendix) large and very persistent imbalances have grown in these accounts. China has arguably generated the largest trade surplus as a share of global GDP in history. Conversely this means the USA must have had the largest trade (if not current) account deficit in history.

China and the rest of Asia has exported capital (purchased US assets) to the US, which in this case has enabled the financing of large amounts of domestic debt both at the state level and the household level, as long end rates fell driving easier credit conditions for these households and easier financing of the welfare state. By exporting capital, the recipient country (the US in this case) imports demand for goods. This demand has been met by higher consumption from build-up of debt instead of unemployment initially. It is no coincidence then that the first signs of BWII unwinding were seen at the deficit end of the global balance of payment equation, as assets rose to a level that could not be sustained by existing or indeed future income.

The 2008 crisis began the process of unwinding, perversely (and inevitably) transferring the crisis to the surplus countries – namely China. The global financial crisis sharply reduced the ability and willingness of other countries even to maintain current trade deficits, placing a downward pressure on China's current account surplus. China responded itself to the crisis by expanding its own credit in the system in an attempt to maintain growth via investment. Unfortunately the imbalances within China are those of an economy that has supported production at the expense of widespread household wealth and consumption. There has been a growing inequality in the distribution of wealth as those who ran production, mainly government officials and related families benefited most.

China has experienced an alarming rise in debt, which it has financed through cheap labour but more importantly cheap capital as dictated by State control of the financial sector. However its financially repressive tactics of low interest rates, partially a function of US monetary policy, has built up a highly unstable financial sector. As we have shown this is especially so as any credit growth is merely wasted capital and not creating any income advantages. We say partially a function of US monetary policy, because

with low US interest rates investors sought yield in emerging markets across the world which exacerbated the growth of credit. This occurred at a time these countries' economies are still export and investment dependent and do not have fully developed domestic economies built on service provision and domestic consumption.

So it is now the turn of the main surplus country, China, in the BW II relationship to participate in the unwinding of this system. But why have we spoken so much about BoP issues elsewhere? The BoP issues of the classic nature ie those with unserviceable current account deficits, such as those we are witnessing in Indonesia or Brazil are merely the symptoms and hence signs of this unwinding process. Brazil and other commodity exporters such as Australia have been supported by China both exporting capital and importing their commodities. This is no longer the case. Asian countries which are effectively tied to the China (USD peg) in order to maintain competitive export markets have seen their rate of FX reserve accumulation falter. This is a good sign of rebalancing of BWII but with the aggressive devaluation efforts by Japan, trade flows in the rest of Asia are beginning to fall, and as the current account falls further the need for more foreign capital to fund them will grow. Unfortunately hot capital flow is not forthcoming as it too is reversing and at a time these countries can least afford it.

The realisation that emerging countries are not the panacea of growth investors thought they were and the reality that yields have compressed too much relative to developed world benchmarks has left many realising that too much of a 'good thing' is priced in. Couple this with real effective exchange rates that have become too strong and with trade balances reversing any currency gains are now equally exposed, even as the rate of currency devaluation is slowed by the mobilisation of large FX reserves. The reversal in bond flows and currencies in emerging markets is thus again just another sign of the continuation of the BWII unwind.

With the credit crunch looming in China it is clear the leadership is trying to undo the excesses of its investment growth model. Ironically, though, surplus countries and those with large FX reserves are likely far more vulnerable to the unravelling of BW II as they do not own the engine of consumption. China and many of the Asian economies, but especially China, is not yet ready to make this adjustment without their being a very disruptive change in their economy and wealth distribution. Any changes in savings and investment dynamics will have equal and opposite effects on the rest of the world. China's growth will fall dramatically and even if wealth distribution becomes more uniform it does mean global growth will be lower as a whole which leads us to believe that many of the assets supported artificially by too much debt are vulnerable in the next few years to much lower prices.

So we will end our ToP of the BoPs session just as ToP of the Pops would do by announcing our number own one. And as we suspect you will not be surprised to see that:

Our # 1 BoP candidate is CHINA.

China is instrumental in the next phase of the BW II unwind. Despite China experiencing large surpluses, as we have intimated this leaves the country the most vulnerable to a balance of payment crisis. So perhaps not one's archetypal BoP but nonetheless the country with the most critical BoP dynamic for global growth and asset classes.

The question that remains for us to debate - will this lead to the selling of their UST - bond FX reserves. This is a complex topic but essential for one to understand when making asset class decisions going forward. We will examine in next month's HindeSight Letter – 'China – Another BRIC in the Wall?' the likely movement of the Yuan, China's FX reserves and the flow of Treasuries and dollars around the globe.

N.B.

We haven't mentioned gold once in this piece – until now. We believe the bursting of the 'Great Bond Bubble' will lead to a formative and substantial rise in gold as official money, institutional and investor money seeks an asset that can protect us all from a global default and resetting of the monetary order. The time to buy gold is fast approaching, if that time is not already upon us.

Appendix:

Background

In our HindeSight Investor Letter October 2010 - The World Monetary Earthquake - the Dash from Cash (play on Chinese currency) we postulated that the Crisis of 2008 was part and parcel of a series of crises which was culminating in the unravelling of our monetary system.

The name for this monetary system was Bretton Woods II and ostensibly came from the work of three economists, Dooley, Folkerts-Landau and Garber (DFG) in their NBER working paper (September 2003), titled, 'An Essay on the Revised Bretton Woods System.' In their own words this system refer to:

> The economic emergence of a fixed exchange rate periphery in Asia has re-established the United States as the centre country in the Bretton Woods international monetary system. We argue that the normal evolution of the international monetary system involves the emergence of a periphery for which the development strategy is export-led growth supported by undervalued exchange rates, capital controls and official capital outflows in the form of accumulation of reserve asset claims on the centre country. The success of this strategy in fostering economic growth allows the periphery to graduate to the centre. Financial liberalization, in turn, requires floating exchange rates among the centre countries. But there is a line of countries waiting to follow the Europe of the 1950s/60s and Asia today sufficient to keep the system intact for the foreseeable future.

We must pay tribute to DFG because it was not abundantly clear at the time of their articulation just how entrenched this system would become over the next decade. It really wasn't transparent that Asia was aggressively funding the US until arguably 2004. It was really only in 2005 and 2006 that we began to point to global imbalances as the root of liquidity excess and asset bubbles. However where we have admiration we also have consternation. We are at odds with their long held view that this system is not inherently unstable and has not been responsible for the excess build up in liquidity and hence asset bubbles.

Bretton Woods: Then and Now

The original Bretton Woods was a fixed exchange rate system in which Western European countries and Japan, most notably, maintained undervalued exchange rates against the US dollar, to pursue of an export-led growth strategy, which led to the accumulation of large amounts of dollar reserves which required capital controls to prevent the disruptive flow of capital. This export strategy helped heal their economies ravaged by World War II. Remember both Germany and Japan had been destroyed and Allied nations having learnt the lessons of history were not keen to exact revenge through crippling war reparations, far from it they sort administrative control to help rebuild them.

The United States thus occupied an asymmetric but centre position in this monetary system, running balance of payment deficits, and providing international reserves to Western Europe and Japan - the periphery countries. The US acted as the export market of last resort for the rest of the world or in other words provided net demand for global exports. They consumed the exports of the periphery in return for financing of its own economy. Essentially it became banker to the world by borrowing from these periphery countries by issuing short term assets (US government bonds) and then making long-term capital or portfolio investments into these countries to support their export-led (and investment) growth strategy.

This was a win-win situation for both sides of the balance of payment relationship. The constraint on too much liquidity building up in this system was in theory based on their currencies indirectly being pegged to gold. The periphery pegged to the US dollar, which in turn was fixed to the price of gold at US$35 per ounce. Unfortunately this was an gold exchange standard that didn't prevent the US from printing more liabilities to pay for its 'guns and butter' program of the 1960s. This led to a build-up of excess dollars and a growing balance of payment deficit with the rest of the world, which resulted in the collapse of the gold pool, rampant commodity prices and commensurate global inflation.

Some have argued that in fact the periphery - Japan mainly, had managed to converge or graduate to the centre, reviving itself as an industrialised and financially advanced economy like the US with a floating

exchange rate and no capital controls. Although some of this is true, in reality Japan has remained an export-led growth nation to this very day.

The 'Revived Bretton Woods' that DFG refer to is similar in that the US holds centre stage and Asia is primarily the periphery using artificially undervalued currencies pegged to the US dollar to advance their export led-growth. Likewise such a system results in massive accumulation of dollar reserves in the form of low yielding US dollar denominated debt instruments (US government and agency debt).

So Bretton Woods II is in essence where much of the world, primarily the Asian countries (but also Petro-countries), have more or less informally pegged their currencies to the dollar, but this time without the backing of gold. These countries do this in order to maintain their relative competitive ability to sell their products to the world and more specifically to the US. So the defining nature of this international and financial monetary system is that it finances the United States' enormous external deficit and the associated fiscal deficit at low interest rates.

In 2005 we wrote to a prospective seed investor that we felt this new system that was advertised as BWII, a semi-fixed exchange rate system, was inherently more unstable than the Bretton Woods. It had created greater global imbalances and a much more speculative environment, as excess reserves floated around the globe. Why? Because there was no gold conversion restraint upon the reserve currency, under BW I the natural equilibrating mechanism of trade balance was the transfer of gold from one country to another. BWI was such a poor substitute for a true gold standard it actually led to heightened risks, as the peg to gold was just to the dollar and only indirectly to the other countries which enabled them the US to surreptitiously build up excess liquidity.

During most of the BWI period, discipline on the United States—the main supplier of global liquidity—was imposed in two ways. First, the United States pegged the price of the dollar at $35 per ounce of gold. Second, it maintained the convertibility of the dollar into gold at that fixed price. If U.S. policies were overly expansionary, the resulting balance-of-payment deficits were paid for by sending dollars abroad. Foreign central banks were permitted to exchange those dollars for gold at the U.S. Treasury, imposing some discipline over U.S. policies.

During the late 1960s and early 1970s, several events transformed the Bretton Woods regime from one based on the convertibility of the U.S. dollar into gold (at a fixed price) to one based on fiat money. In this connection, prior to 1958, less than 10 percent of cumulative U.S. balance-of-payments deficits since the end of World War II had been financed through U.S. gold sales; from 1959 until 1968 almost 67 percent of the U.S. cumulative balance-of-payments deficits were financed from U.S. gold reserves (Cohen 2001). When the Bretton Woods regime started, the United States held about 75 percent of the world's monetary stock (Meltzer 1991); by 1968, the U.S. share had declined to about 25 percent. To preserve its remaining gold stock, the U.S. took measures to sever the link between the dollar and gold. The rest is history as we say.

Today core and periphery countries are more heterogeneous in nature than they were under the first Bretton Woods. Under BW I the common experience of World War II was enough to maintain the status quo for a while, but today even allowing for the common experience of the financial crisis there is no such common bond. As the excesses have built in the system it is clear that it is becoming every man for himself. Japan has set the marker.

Despite stern rhetoric from US Senators like Shelby and Schumer, the US likely has little incentive (even allowing for Shale gas revolution) to precipitate the essential and inevitable BoP adjustment. The BW II arrangement allows the US to live beyond its means, so to our mind we have felt it was likely the exchange-rate adjustments would be forced by Asia intentionally or unintentionally. (We would note Michael Pettis, a Chinese economic expert believes this not to be the case; we will address this in next month's letter.)

The conscious decision could be made as Asia's (notably China's) industrial and financial convergence to the centre country would likely lead to less export-led growth as recognition that just selling trade merchandise is not conducive to their longer-term productivity. The clear next focus for such productivity enhancement would be to improve service development and education, again in acknowledgment of the necessary tapering of fixed investment infrastructure, which would likely be susceptible to misallocations of capital ie

overcapacity as a consequence of stresses built up in their own highly developing economy expanding too fast on excess dollar creation. We believe this is underway but the excesses that have been built up are too great for the process not to be a very disruptive one. In fact the process of unwind is happening before China can implement a controlled rebalancing internally to assist with the global rebalancing of balance of payments.

China began its liberalisation of the capital account in 2005 by moving from a fixed peg to a managed float. This was briefly suspended in 2008 during the crisis and reinstated in 2010. Despite a few years of excess dollar accumulation in Asia, (remember you have to stop the super-tanker first before you can back it up), this marked the beginning of the unwinding (rebalancing) of this vendor-finance relationship. Such an unwind was clearly going to be precarious as the engine of growth has been driven by credit supplied by the US as funded largely by Asia.

In a global monetary system defined by fiat currencies, with a large and powerful centre country (US) whose central bank operates in the absence of a convertibility principle linking the dollar to gold, floating exchange rates are essential, not only across all major currencies, but the countries of the periphery (Asia, Latam, and Middle East) as this would provide a better mechanism for the adjustment of global imbalances that exists now and reduce the likelihood of catastrophic financial crises. This is because under pegs it's much easier to build up monstrous surpluses and reserves without the market being allowed to rebalance such flows.

BoP Accounting Identities (Pettis 2013)

1. Current Account + Capital Account = Zero. The Balance of Payment should always balance.

   (ie the sum of dollars entering the country and dollars leaving the country is always equal to zero)

2. Current Account Surplus or Deficit = Total Domestic Savings - Total Domestic Investment = Net amount of Capital Imported or Exported

   -If a country experience excess savings relative to investment then those savings must be exported abroad ie capital is exported, and that same country must imports that capital back in in the form of a current account.)

   -Exporting capital is the same as saying you are importing demand given that the country who exports capital abroad must run a current account surplus

3. Total Production – Total Consumption = Excess Savings

   -Everything that a country produces must be either consumed or saved. The total goods and services that a country produces = Gross Domestic Product (GDP), therefore a country's savings can be defined simply as its GDP – total household and other consumption

   If everything that a country produces is either consumed or saved, and if the excess of domestic savings over domestic investment is equal to a country's current account surplus, then it follows that that everything the country produces it must consume domestically, invest domestically or export abroad.

   A change in one country's trade balance must be matched with an opposite change in the trade balance of all other countries, there must be also an opposite and equal change in the gap between the total domestic savings of the rest of the world and the total domestic investment of the rest of the world.

   Note: Clearly the implication is the savings rate of different countries are linked through the trade account.

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