

## Holland Macro Views

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# Revisiting Mickey's Fantasia

### Executive summary

Inflationist's continue to bang their bearish drums but the equity market moves ever higher. Can this continue and for how long? Changes are clearly taking place in the West's relationship with China with it now a source of inflation as opposed to the once welcome deflation that helped keep our asset bubbles aloft. That said current western speculation of China's demise could be greatly exaggerated. UK and US fiscal policy have never been more different. Maybe both are right, but each comes with its own risks. We look at a few of these things below.

### Are we living in another fallacy? – Does it matter?

With the forecasting consensus so biased towards an inflationary future it seems almost embarrassing to admit that I was (remain?) for a long time a deflationist believing that it was the logical scenario that followed a credit collapse. That was all of course before the once (or twice!) in a lifetime event which was money printing. After which it was necessary to be a little more pragmatic.

I tried to do just that in a piece I wrote in May 2009, entitled *'Does fantasia replace goldilocks'*. In it I asserted the view that the 'goldilocks economy; neither too hot nor too cold' was in hindsight clearly a fallacy, but a very believable one. The world as we knew at the time was clearly too hot. I further suggested that the near future might not be one of inflationary or deflationary extremes that were so convincingly argued by clever people. It would be more likely another fallacy. Mickey's sorcerer's apprentice and his broomsticks in Fantasia came to mind. With a new spell cast from the wizard's book (Money Printing) the dry well would soon be filled with liquidity.... and so it was. I went on to observe that the spell would ultimately have consequences likely overflowing into inflation, as so many now in 2011 expect. I also however observed the following:

*'But imagine we found ourselves in a situation where gilt yields had not risen and governments' continued to be able to finance their stimulus plans. If this were then combined with growth that was just a little better than investors expected, we have the recipe for what would look a lot like a bull market' (aka: today)*

Not a bad guess on my part. Nearly two years on and that is exactly what we have had. Low bond yields and ever rising share valuations as a result. Today the views of the bond bears remains and there are still very few bond bulls, i.e. very little has changed, except equities keep rising. Of course with such aggressive money printing bond bears will likely, one day, be right but for now Mickey's Fantasia continues to give us the perfect, if unsustainable mix of low interest rates and cheap(ish) stocks. In seeking to update these and other macro views today maybe we can do so under some headings I have also used in the past. The three pillars that have formed the backdrop of investment in the last 10-20 years:

- **Labour vs Capital**
- **The East (aka) China vs The West**
- **Asset speculation**

I observe again as I did in 2009 that these were the investment constants before the Great Recession and I suggest for now remain so. I will not add to past comments on asset speculation but feel a few reflections on the other categories may be appropriate.

### **East (China) vs West**

There was a wonderful era when we in the west imported Asia's deflation and it matched almost perfectly our western asset inflation. How we loved it. Without working we got wealthy and yet the cost of living stayed low.

How so many people yearn for those days. Later on this same Asian deflation, and by then collapsing Western asset prices, also meant the world was able to cope with Western money printing policies.... to start with. However, now western money printing is starting to show up so strongly in the BRIC countries so that each in turn has needed to raise rates in the last few months to tackle domestic inflation. So now we have Eastern inflation and Western asset price inflation too. The result of which is that we must be getting closer to the consequences of Mickey's spell I outlined earlier. No longer are global forces offsetting each other. The consequences of this change might not be as disastrous as the bears wish you to believe but it is important we accept that this relationship is not what it once was.

#### [Mervyn tells it like it is](#)

For some time I have taken issue with inflationary bears on a number of points. This includes the fact that after past credit collapses bond yields stayed low for a long time, importantly meaning that governments could, perhaps surprisingly, finance their significant deficits. The other objection I have with a wooden inflationary bear stance is that there are different types of inflation. Asset price inflation and wage inflation by example move often in an unrelated manner. QE policies have created the asset price inflation that was required to fight deflation but they do not necessarily create wage inflation. This would only occur if there were tightness in the labour market or the politics of society was more socialist in orientation. We still look a long way from either of these scenarios. Mervin King's speech last week made this very point well, observing that wage rises will need to lag the cost of living for some time yet. This observation works on many levels. It is what the Bank of England actually wants to happen to limit lasting inflationary pressures and openly discussing it helps stop the UK's shock absorber (Sterling) from rising in value. Well said Merv!

### **Labour vs Capital - Embracing frugality**

With some western populations currently embracing frugality there is a good chance the Governor's speech could come true. With only c.14% of our income needing to be spent on food maybe we can, as a population, take it on the chin for some time to come. The only other option our society has is a much more socialist agenda where a greater percentage of GDP goes not on corporate profits but on wages for workers. Surely however, if this happens it will only do so on a more global rather than local level as I have discussed before. Socialism did follow the capitalist 1920's but such a change in the wind does feel a long way off. We must remember however that similar rises in the cost of living in the East is having different effects. In the developing nations (if Goldman's still allow us to call them that) food accounts for 40% of personal incomes not 14%. It is not surprising therefore that with little spare capacity and such cost of living pressures, real inflationary forces are therefore occurring.

### The Crux

The crux then surely is whether the East, BRIC's, call them what you will, can slow themselves down while still growing fast enough to avoid a global slowdown? My answer to that unhelpfully 'maybe'.

Much is made of the danger that could accompany a collapse in China's growth rate. With past growth rates hard for us in the west to comprehend we are often in danger of assuming overheating rather than analytically proving it to be actually likely. The scale and scope of future economic potential in China and the surrounding areas remains colossal and the impact this has on the global growth rate is now clearly significant. This is shown by an excellent diagram in a recent FT article which shows how significantly Chinese trade with different countries around the world has changed (see attached). For example, 3.5% of US foreign trade was with China in 1992, by 2010 it was 14.3%. In Australia the changes are even more significant, trade with China going from 3.7% to 20.6% over the same period. China bears will find such a chart concerning, but if China and BRIC nations can slow inflationary pressure but still grow at good nominal rates they will continue to be a huge benefit to the wider global economy not a hindrance.

### Some ground work

I recently returned to Thailand for a family backpacking holiday, having last visited in 1994. The contrast was amazing and maybe instructive for us. I observed two significant changes:

- I remember Bangkok as an oppressive and horrendous city to travel around. Bearing in mind its population has doubled since my first visit I was staggered by what I encountered. The infrastructure was excellent with new highways and an overhead City Subway (Sky train). This meant travelling around the city was as easy as many in Europe. The highways infrastructure in the rest of the country had changed beyond recognition too
- On leaving the UK I had grabbed a few hundred US dollars that I had in the house to spend while I was there, remembering from my last trip that everyone we encountered wanted dollars rather than Thai Bhat. Again the situation has changed markedly. I almost could not give the Dollars away with people insisting I go to change them into Baht before paying!

Maybe there are two wider lessons here for our East vs West investment view. Firstly, yes a large amount of commodities have been used to build infrastructure in many developing nations and maybe this does not need to reoccur at the same rate, but that does not mean they have overdeveloped. The important consequence of this infrastructure is the productivity of the wider economy which is improved significantly resulting in more investment elsewhere (factories, hotels) which I witnessed firsthand in Bangkok. Ask yourself the following question: "Once the railroads and highways were built in the US did that spell the end of its economic prosperity?" Of course not, so neither does it necessarily mean it will in the East. Past volatility in Eastern economies suggest to us a level of concern about future growth that *might* not be appropriate. Arguably many parts of China's development have been looked at from a very sustainable perspective, far more so than in parts of Europe or the US in recent years. Returning home with all my US Dollars suggests also that any debate on reserve currencies etc. is just pointless. London and Manhattan based asset allocators may take a decade to change their minds as to which currencies have potential and which do not but small business men the world over make their choices much faster and in their eyes the dollar is already mightily depressed.

### **UK and US Economic policy contrasted**

These two countries have followed very similar economic policies for much of the last 40 years. Today there is an interesting contrast. This is because of the different states of both their employment and housing markets. Current US fiscal policy is a function of spending which was ramped up by one party pre recession but which has also been sustained by the opposing party after

it. This was a reaction to a massive wealth hit due to housing market falls and significant unemployment levels that resulted. The policy has been sustained because of the fear of the economy quickly deteriorating further were any fiscal stimulus removed. With such uncertainty maybe this policy is arguably 'prudent'.

UK policy is the opposite and predicated on the view that fiscal rectitude must be quickly restored. Others in Europe have had this policy forced upon them so doing so voluntarily seems of great sense to many market observers in London. I suggest UK current fiscal policy is *probably* right. However the contrast with the US could suggest that:

- Risks to growth (and inflation) in the US are on the upside
- Risks to growth (and deflation) in the UK are on the downside

In the face of each distinct economy each policy's merit can be seen, but what if we are yet to see the full picture. What would the UK conservative party policy be if a second deflationary global downturn hit or the UK housing market finally cracked? Would it reverse its policy to match that of the US? Could it? Worryingly I somewhat doubt they would as likely this would be political suicide. Let's hope we don't have to find out.

Now let's assume (which not all will agree on) that broadly UK and US Central banks longer term inflation fighting credibility remain intact, which despite the commentary of bond bears and gold bugs, current yields do still suggest. Were that the case, US policy gives more room for error than in austerity Britain. Both continue to agree on one thing however. At no cost let your currency rise. The unusually outspoken language of each central bank head is regularly seeing to that.

#### [Another book](#)

Before leaving the world of macroeconomics I would highlight a great book I read in Thailand called "Collapse" by Jared Diamond. Despite the annoyingly alarmist title it is an interesting look at ancient societies, like those on Easter Island, and what forces meant some of them prospered for hundreds of years while others collapsed. I felt the book had a number of parallels both for modern economies and for the company's we look to invest in. At some stage I will try to write this up more fully. What was alarmingly clear however was how each society played a significant part in its own collapse by over exploiting their land or trying to grow too fast when times (climate) were good. Many of today's damaged economies are those that also tried to grow too fast via easy money created wealth. 2000 years ago the price paid for the over-exploitation of lands was hunger, starvation, civil war and death as there were too many mouths to feed when conditions worsened. Today the price is the length of the unemployment line that the strength of the recovering economy just cannot repair. The contrast between youth employment rates in the US or Spain compared to Germany is depressingly illustrative of this as is Tim Geithner's recent admission that the "*US Recovery is tragically moderate*"

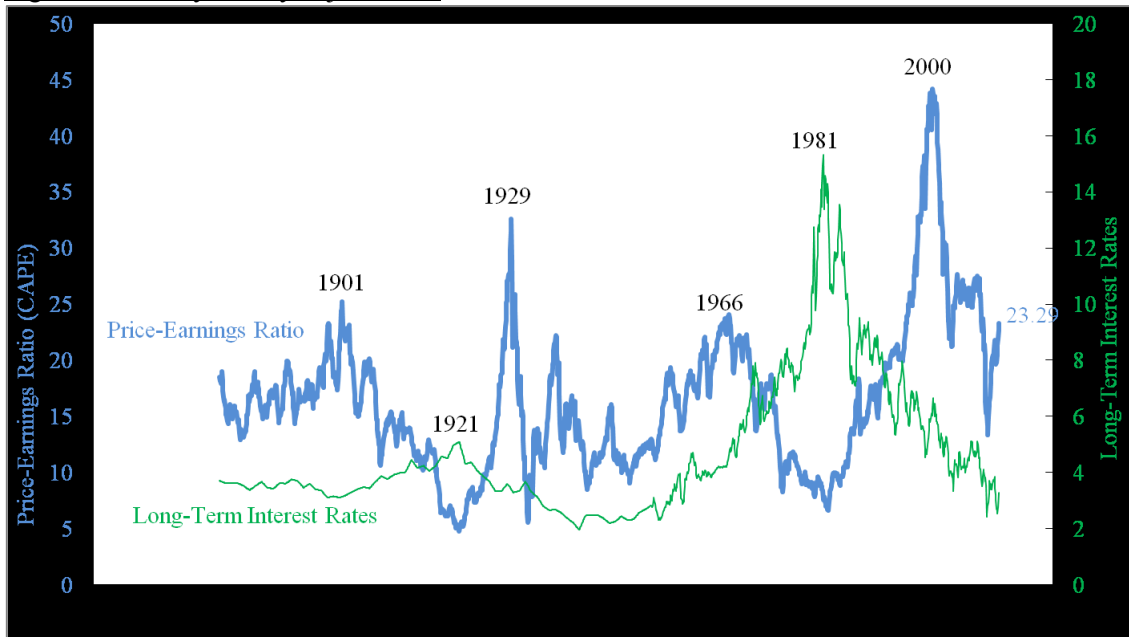
### **Are Markets too high?**

Many are keen to analyse bond equity ratios or look at other market valuation charts like the Shiller cyclically adjusted PE shown below. This chart I think is pretty compelling and all investors should consider it, especially at points of extreme optimism or pessimism. Some of the greatest investors that ever lived however usually ignored overall market levels for the very good reason that they are so hard to predict.

The peak of Shiller PE chart shown overleaf was 2000 which we all remember well. It produced a level on the S+P that has still yet to be surpassed. But at that peak of market valuation there were still individual bargains to be had. Diageo was then priced at c.470p.

When the stock market troughed some 3 years later Diaego had risen to 630p and today it is 1258p. This is clearly the attraction of paying low prices for powerful companies that compound at good rates, irrespective of market levels. This is just one example of how market timing can cost you dearly if you miss out on the compounding power of great companies. Let's let the Sage have the last word on this one. Buffett: "*Keynes essentially said don't try and figure out what the market is doing. Figure out businesses you understand and concentrate*".

Fig. 1: Shiller Cyclically adjusted PE



Source: Robert J Shiller "Irrational Exuberance" Princeton University Press

## What to own?

For the last few years my recommendations have been similar. I have recommended the highest quality franchises and on occasion safe assets such as Gold.

### Gold and currencies

A decision to own "safe" assets a few years ago was an easy one. As such putting money into Gold and Swiss francs made huge sense. Part of what make assets "safe" is their predictability, the other part is surely the safety they offer of your principle. I am fully aware of the debates for both Gold and better currencies but now just question whether they are as "safe" as some of the newer fans suggest (NB: this was written before Gold's last wobble and I still own some!). Owning treasury bills that pay 1% in US dollars is probably foolish, but if we can find other assets that can compound at faster rates (8-10% pa) then further currency depreciation is maybe of less of a concern. The price of Gold vs AN Other currency over the last 100 years is often trotted out as evidence to undermine paper currencies. This point is fair but only if you assume you did nothing with that money. I.e. you have never seen a compound interest table. I think there are no easy calls in currencies or gold any more. The safe havens have been found and now are likely priced as such.

Sterling remains interesting; it would fall further with a housing collapse, but without it may likely strengthen due to fiscal rectitude. Deep down it is hard to be bullish on a non-reserve currency that is printing money however. The Euro is also not the easy bearish call some suggest. Clearly there are problems, but equally its largest nation state, Germany, is arguably exporting from currency that is far too low in value. Of interest also is the recent participation in troubled Euro states bond financing by Japan and China. Are they crazy? Maybe not.

They pick up a 6% coupon rather than the paltry 1% offered in US TBills. After five years therefore they could cope with an exit from the Euro and a >25% currency devaluation and still come out flat. Equally their very participation suggests that such an outcome is less likely and they get to support a global trade counterpart currency too.

### Equities

In spring 2009 I was pleased to have become more bullish, but I recommended the wrong things suggesting that it was a great opportunity to buy great franchises. I was right it was, but it was an even better opportunity to own worse franchises. As the marginal producers they had the most to gain by improved fortunes in their profits and therefore their shares recovered more strongly than better quality competitors. In hindsight this was no surprise and a little more historic reading tells us this is normal at market turning points. The length of outperformance by lower quality shares has surpassed expectations and many of us have looked for reasons why higher quality companies still, in large part, lag in share price terms. I suggest QE policies maybe do the same as a recovering market as they help the marginal producer more than the established one (who is less financially or operationally geared). As this is the first time any of us have ever seen QE maybe that explains the trend we have witnessed? That all said we are a long way down such a second tier recovery now. The valuation and quality being offered to us in high quality global franchises remains compelling. Some have rallied, others not. Very few of the really great companies we still find are expensive. What I have also learnt on closer inspection is how a great number of them are lowly geared and a good proportion allocate capital exceptionally well, particularly those quoted in the US. Many of which are now aggressively, and rightly, buying their own shares back. Please ask for a full list of our recommendations and as we said last year *“Reach for a bucket not a thimble.”* We also re-iterate the view that in a world where asset classes have become alarmingly correlated owing assets with shorter duration could pay great dividends were things to turn ugly. Occasional purchases of corporate bonds or arbitrage opportunities therefore is something we think all investors should also be doing.

### **Last word**

I used to write lot of a macro pieces and revel in the different view I had on the world. Two things stop me doing this so much now. Firstly my views are a little less contentions these days as maybe there are less bubbles to shout at! The second is that the more I have understood (?) better company analysis the more I have realised how great the margin of safety is in stock selection can be and by contrast how great the margin of error in macro and strategic forecasting is. With all that I thank you for your patience if you read this to the end and will repeat the brilliant John Galbraith quote

*“The function of economic forecasting is to make astrology look respectable”.*

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