MACRO VIEW: Von Mises' Revenge

For the Austrian school of economics – hallmarked by the views of Von Mises, Hayek etcetera – it's been six long years of winter. Ever since 2009, alarmist expectations of runaway inflation and all-around disaster have not (yet) come to pass. Perhaps the biggest red herring was that famous chart, which all Austrian enthusiasts recall, of the Federal Reserve balance sheet shooting up into the stratosphere. With all that insane credit creation, how could rampant inflation not have been the follow-on result? With so much blatantly manipulative control wielded by the Federal Reserve (and central bankers everywhere), how could the world not reap what it sowed?

In understanding what could happen to the global economy (how all of this could end), it is perhaps useful to first be aware of just where the Austrian school went wrong (in the popular sense that is… not at all automatically assuming that every Austrian practitioner made the following catalog of economic errors). In general terms, here are some things the popularized version of Austrian economics badly botched:

The false notion that Federal Reserve QE (Quantitative Easing) was the same as "printing money." This error was especially obnoxious because it was so widespread, and so wrong. It is important to remember that words mean things, and that a bad definition can be worse than no definition at all. Thus to say the Fed was "printing money," when that is not what was happening, is to sow confusion. There exists a major difference between 1) a "helicopter drop" of cash, which didn't happen, and 2) asset swaps which add liquidity to bank reserves, which are more or less what did. There was in fact a very powerful QE effect… but not in a money printing sense, as if consumers had received extra money in their mailbox. Instead, the impact of QE came through artificially lowered interest rates and expanded willingness of banks to lend to blue chip corporations, which in turn fueled financial engineering, reaching for yield, and a paper asset boom.

The false notion that all inflation is the same. This was not said out loud, but largely implied. The vision of a big spike on the Federal Reserve balance sheet led to images of runaway inflation, in turn invoking memories of the 1970s and prices running haywire. But that is not how inflation works. You can have many different types of inflation, and you can actually have inflation in one pocket of the economy, yet deflation in another pocket, at the exact same time. The past six years indeed saw meaningful inflation of a certain type: Most all of it went into **paper assets and liquidity-sensitive stores of wealth.** This is a real and legitimate form of inflation, but clearly very different from what so many were expecting…

The false notion that America has a lousy balance sheet. Yet another widespread belief was (and is) that the United States is debt-addled, burdened with a truly lousy balance sheet. But this view makes little sense in light of America's trove of valuable property and cash-flow-producing assets running into the uber-trillions… not to mention a host of intangibles that underscore all the reasons why the USA remains a global superpower. It surely makes no sense to assume a company is doomed because it has borrowed "a large sum of money" without also being aware what that company's cash flow position is, and how it is positioned vis a vis competitors. The same logic applies to countries. In assuming, say, that the US bond market would disintegrate, nobody bothered to assess how much elbow room the USA might have to leverage an asset base that was not actually that leveraged to start with.

A Calvinist view of debt as sin requiring retribution. There is a broad view that debt is evil and accumulating it is sinful. The degree to which this view drives a culture can have big impact on worldviews and policies (for ex. note Germany). But this view is distorted from a pure economic sense. It isn't always clear that borrowing is bad. Such depends on how the money is spent, and the strength of the asset base borrowed against. A knee-jerk reaction to debt (in the general sense of things) led to assumption that sinners would be punished. But this view was too simplistic, and also overlooked saintly aspects of the USA's position. If debt accumulation is a form of moral cost, then what about the build-up of surplus on the positive side of the ledger born from American innovation, corporate dynamism, entrepreneurial agility and so on? The sinner versus saint view, in all the ways it is unhelpful, also tends to overweight the sin side and downplay the offsets.

A time frame mismatch in light of extended macro cycles. Another clear mistake was assuming that, just because the powers that be (global central banks) had built up huge amounts of debt, the fallout would have to be imminent. But why? We know that, in terms of macro cycles, six years is not necessarily enough time to even complete a single spin of the merry-go-round. If global financial crisis rolls along every five to seven years, as it has seemed to for a good while now… then why would this aspect of the cycle be any different?

Hyping precious metals while missing wage suppression. The focus on gold and silver as antidote to central bank folly was out of logical synch with the environment. As already noted there are different types of inflation. Paper asset inflation will tend to favor yield-producing assets and real estate, not precious metals. Meanwhile it is hard to assume inflation will show up in the traditional ways when wages are stagnant or flat! Historic US inflation had wages rising, driven by unions with pricing power, coupled with other reasons for the price of goods and services to keep getting bid up. These past six years however, wages were suppressed as corporate USA rebuilt its profitability – a benign inflation combination.

One final trap that Austrians fell into, especially in regard to that expanded Fed balance sheet, was forgetting to balance the visible creation of public credit against the less visible destruction of private credit. In the aftermath of 2008, many trillions worth of private sector credit simply vaporized. The credit creation efforts of the Federal Reserve may have been like air-dropping a mattress into a volcano by comparison.

With all the above said, it is not at all clear that the Austrian school is discredited. **If anything, the logical core of Austrian economics seems more useful and on point than ever…** as long as one does not fall into one of the many hidden pitfalls or traps (a few of which are mentioned above). Consider:

- The "full cycle" of market conditions is not yet complete
- Short-term benefits with delayed consequences are typical
- One doesn't know the full cost of the bill until one has paid
- China is the grand offender of Austrian economic thought
- We are now seeing China's chickens come home to roost…

One of the most important concepts in Austrian economics is the misallocation of capital. When free market signals are badly distorted, governments and businesses make lower quality investments, or even flat-out terrible ones. These illogical investments lead to lowered productivity and waste build-up throughout the economy. Eventually this build-up of "muda," the Japanese word for waste and wastefulness, leads to a forced reckoning, in the exact same fashion that, if a business is run poorly for many years while living off credit lines, the costs of those decisions are eventually born out.

Another key Austrian concept is "Katastrophenhausse" or "crack-up boom." In a crack-up boom, an orgiastic frenzy of spending and gross capital misallocation, driven by liquidity and greed and optimism turned to euphoria, leads to a sort of "party for the ages" before it turns to disaster as citizens realize that their money, upon threat of becoming worthless (in this case literally "worth less"), should be quickly spent or otherwise turned into something other than cash.

One could say China is now confirming the Austrian thesis. This is a curveball, because so many "doomers" expected the Austrian comeuppance to take place for the United States. But as we have pointed out repeatedly in these pages, the fiscal position of the USA is actually far better than many are willing to admit when "positive side of the balance sheet" factors are taken into account… and in the same vein China's position is actually much, much worse than it appears. For instance, much is made of the fact China has three or four trillion worth of foreign reserves: But nobody really digests the fact that an estimated trillion-plus was just now spent on foolhardy efforts to stabilize China's equity market, with debt and derivative exposures in the many trillions beyond that amount. **China's fiscal accounts are closer to "Enron" than to the rock of Gibraltar,** despite what many believe!

For multiple decades China has appeared to defy the laws of both gravity and complexity, avoiding economic recession and political crisis through top down management. There are two ways to interpret this: Either the mandarins in Beijing have found loopholes allowing them to bypass the realities of free market economics, or they have been saving up the costs for one hell of an aggregated bill when crisis hits. The second view is hallmarked by problems building up below the surface, and this seems the case. **So where does the Austrian view apply? Consider Von Mises' "prophecy:"**

There is no means of avoiding the final collapse of a boom expansion brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved.

When Mother Nature finally demands payment, the Austrian school argues, she can get it via one of two ways: Through a painful adjustment in the credit-pumped economy, or an even more painful adjustment to the currency. It is often the case that the currency is sacrificed to save the economy: This is known as "default by another name," in which debt burdens are reduced by paying with deeply devalued paper.

But here is another thing: **The global economy is deeply connected now… so the actions of one player have heavy impact on another.** We can think of "the currency system involved" as being represented by all countries, with various levels of strength and weakness therein. And so, when China makes extreme choices, the ripple of impact is felt across the globe… **and the weakest players tend to feel it first.** In fact there is a general "pecking order" of consequences based on economic strength. The stronger a country is on a standalone basis, economically speaking, the better it can weather big policy moves by, say, China or the United States. The weaker that same country, the more that movements from the "big dogs" will impact its fate, often for the worse. **This is broadly why, if China continues to flail on the path to economic meltdown, it is emerging markets who will feel it most.** The "destruction of the currency system involved," as noted by Von Mises, then applies to multiple currency systems, even as various emerging markets engage in "currency war" to help boost export sales, while reducing the repayment cost of expensive dollar-denominated debt. This is the channel by which capital misallocation (which many EM governments are heavily guilty of) develops **knock-on potential for currency crisis, as China exports deflation (via devaluation and lowered prices) to its neighbors.** This, in turn, could fuel some serious "risk-off" drama, as anyone who remembers the late 1990's Asian currency crisis may recall. The flipside of "survival of the fittest" is turbulence for the weakest…

THEMATIC VIEW: Submerging Markets

We are headed for another global financial crisis of some kind... most likely a rather sizable one. This simple statement evokes all kinds of emotional reactions, depending largely on the point of view of the person who reads it. But really, can't it also be viewed as a simple matter of probability? Looking at the history, this kind of thing happens every five to seven years or so, as the below via State Street makes clear:

Year	Event
1973	Oil Shock/Stocks Crash
1980	US Recession
1987	Stock Market Crash
1994	Bond Market Crash
2001	9-11 / Stocks Crash
2008	Subcrime / Stocks Crash
2015	EM/Stock Crash????

What is the logic behind this apparent "seven-year itch?" Is there some kind of mysterious force that makes everything go to hell every seven years or so? We would say "Nope, not really." For one thing, the dates are accurate but deliberately tweaked a bit: One could say the dotcom bubble crashed in the year 2000, for example... or that the global financial crisis got rolling prior to 2008... and that other tail risk events of major proportion were left out, like the Asian currency crisis in '97, the Russian default in '98, the Greek crisis of 2010, and so on and so forth. Broader point being, **there is no magical aspect to "seven years"... but at the same time, a period of five to seven years IS roughly in synch with how often major financial market dislocations tend to take place.** As to why this is the case, we see a logical middle ground between a belief in mysterious forces (e.g. "waves" of unknown nature) and understanding of human cyclical patterns that repeat for logical reasons, like the 17-year Cicada cycle or the standard stages of madness in crowds and the time it takes for emotional cycles to play out (apathy, skepticism, optimism, euphoria, delusion, anger, denial, despair – at which point the loop then repeats). We can also look at hard "machine" style factors of the type Ray Dalio describes, via Bridgewater worldview, with the entire world as the machine: Build-ups of credit and leverage... historic behavioral patterns in light of rational hidden drivers behind economic cycles, and so on. **As of now we see Austrian cycles of capital misallocation coming to bear in China... with painful implications for E.M.**

Why emerging markets yet again? And why will it necessarily be EM countries that pull the pin on the hand grenade if "everyone is talking about it?" Let us quickly address the popular habit of shallow contrarianism via grabbing it by the shirt collar and headbutting vigorously. First, there is a trader aphorism that says "The best trade is the obvious trade." This is not always true (there are exceptions to the rule), but it is <u>often enough</u> true to be worth thinking about. Second, when people say "Everyone thinks X so maybe it won't happen," they often have zero sense of statistical sampling bias. It may be that "everyone" is actually a tiny sample relative to the general investing population. Or it might be that "everyone" encompasses a large portion of the trading community, yet leaves out the far larger <u>institutional</u> community, in which case it becomes possible for traders to have a "consensus" view juxtaposed against a much larger exposure running the opposite way, as such to be the proverbial sparrow on the hippo's back. (This may well be the case with the USD; when someone says "everyone" is long the USD, meaning traders, they leave out the fact that the USD carry trade unwind has multiple trillions worth of non-trader squeeze potential.) In fact, the very best trades are the ones where traders almost don't count as a factor, because those on the other side, i.e. institutionals, governments, the bagholding public and so on, are such an exposed mass that traders could not eat all the available profit if they wanted to (like a modest school of piranhas attempting to devour an immobilized blue whale).

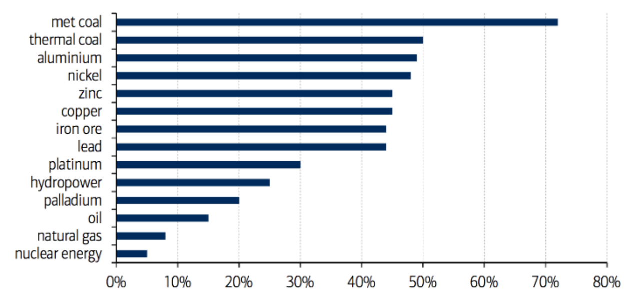
Hopefully this pre-emptively heads off the herp-derp "Yeah but if traders think it's EM then it will be something else LOL" type responses. So what are the causes for thinking that, yes Virginia, EM is where this crisis is likely to kick off? We start with price, one of the most reliable fundamentals:

First and foremost, it's been a long time coming! There was a lot of excitement, prior to the global financial crisis, about how this was going to be the "emerging markets century." Then 2008 happened – and in broader terms, it slowly sunk in just how much time and seasoning it takes to build truly resilient and robust free market structures. (A USA specialty.)

For those not satisfied with pure price rationales – and hey we don't blame you, neither are we – it's all about exposure levels, debt build-up, and hostile monetary policy. To wit:

- E.M. is most exposed to China-driven commodity collapse.
- E.M. has elevated levels of dollar-denominated debt.
- E.M. is most exposed to currency and trade war fallout.
- E.M. is most exposed to Federal Reserve tightening.

Chart 4: China's share of global commodity consumption
With the exception of oil and gas, China is the world's largest consumer of most commodities

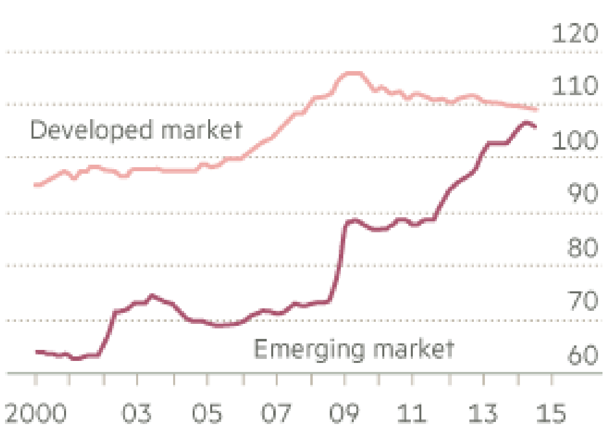


Source: BP, Antaike, IAI, ICSG, INSG, CRU, Woodmac, Metal Bulletin, BofA Merrill Lynch Global Commodity Research

First look to commodity prices, which have collapsed faster than the TV ratings for "Keeping Up With the Kardashians," and consider that 1) global commodity consumption is driven by China and 2) global commodities are largely supplied by emerging markets. The world is now adjusting to the reality that China's endless growth may well and truly be ending. The Ponzi capex boom had to cease and desist at some point, and even China's broad demographics are turning south.

Emerging market private non-financial credit

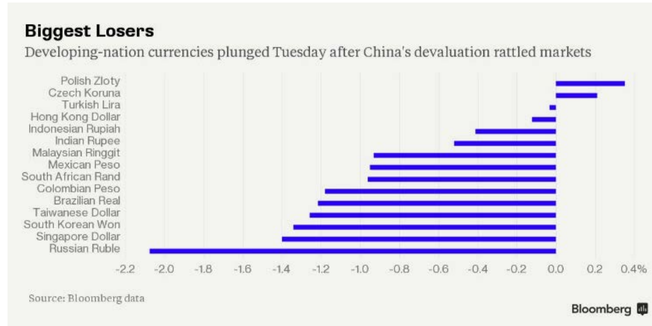
% of GDP (bank credit plus debt securities)



Source: JP Morgan

FT

Next consider the fact EM countries spent the past six years doing something ill-advised: **Racking up <u>ever higher levels of debt</u> (even as developed world countries cut back on debt).**



Meanwhile, when China announced a surprise devaluation of the yuan last week (the largest in decades), the decline among various EM currencies was like a Who's Who of pain. And yet the size of the devaluation, a mere blip in the big scheme of things, was the smallish appetizer at the beginning of a large meal: All involved expect that more, perhaps much more, devaluation will be coming. In fact China may have quite by bumbling accident <u>guaranteed</u> the need to devalue further: Fears of a further weakening currency could now accelerate capital flight via investors and mainland Chinese, making an existing problem an even more serious one. This problem has knock-on effects on economic slowdown, China's biggest problem at all. Another large devaluation, just getting it out of the way, would both help exports further and "rip off the band-aid" (thus causing capital flight to stop). But such an act – not to mention China's willingness in general to "export deflation" by cutting prices – is extremely harmful to EM nations (which have racked up large debt levels). This in turn means more currency war on deck, with emerging markets the players least suited to handle it.

Then too, on the United States side, you have a Federal Reserve itching to hike interest rates… with a historical track record of ignoring the pain of other countries in deciding what monetary policy is best for the USA. Given America's status as the world's largest economy, with 20-25% of global GDP or therabouts, the monetary policy for Uncle Sam is by and large the policy for everyone. This means the beginning of a hiking cycle serves as fiscal tightening for debt-leveraged EM countries… who further complicate the situation having racked up trillions in non-local dollar-denominated debts.

Last but not least one should consider that the price of oil is crashing, and could be headed for $30 a barrel… and that any "risk off" trigger elsewhere in the global asset complex – as with an abandonment of energy debt for example – could lead to follow-on rampant selling in EM as one of the most vulnerable areas of the global economy. Put it all together with price, data and events all confirming the gloom (Brazil debt was just downgraded to junk as China slows day by day) and it is not hard to see just how the tightly coupled complex system that is global markets faces blowup risk via EM.

SPOTLIGHT: Currency War Winner

In recent months, US corporations have been complaining about the material headwind of a strengthening US dollar. The S&P 500 derives almost half its earnings internationally, and a too-strong currency makes that harder to do in all kinds of ways. When an exporter's currency is stronger, it makes their goods more expensive to overseas buyers. This gives the exporter three options: Lower prices (and thus profits); keep prices the same with lower sales (because the products are more expensive, currency-adjusted); or just "suck it up" (to use a Mungerism) and become more competitive. This is comparable to sport rowing with a fierce wind blowing in the opposite direction. Winning just becomes that much harder.

Rather than shed a tear for struggling US exporters, however, consider what the Japanese export champions have been through. Prior to the 2008 global financial crisis, the yen was trading in the 125 per dollar range (similar to its range of today). And then the yen grew freakishly strong. At its peak strength point in 2011, the yen had risen to 75 yen per dollar… a 40 percent increase in value. It is hard to describe what kind of havoc this wreaks on exporters. If the US dollar were to strengthen by 40 percent, many Fortune 500 entities would be crushed. And yet the world champion Japanese exporters – led by Toyota, who we'd written up in a previous SIR – managed to soldier on. As capital allocator Mark Yusko puts it, if Japan's exporters held their own at 75 yen to the dollar, think what they can do with the currency weakened to 125 yen per dollar… or even much further, to 250 or 350! The gist is that Japan's exporters are champion sport rowers in the face of a massive currency headwind… and prospects for the yen to further dramatically weaken mean their profits could absolutely explode. One can furthermore enhance the profit in this idea with a yen currency short side overlay.

This is precisely the core logic behind DXJ, the WisdomTree Japan hedged equity ETF. This ETF invests in Japanese stocks, while hedging against non-dollar currency exposure via short overlay of the Japanese yen. DXJ is intriguing because both sides of the trade have genuine merit: Japanese stocks have a lot going for them, and so too does the short side of dollar/yen (a trade we also maintain through direct exposure on the currency side).

In sum we see Japan's exporters as "currency war winners" because they are tough and seasoned fighters, used to the headwind of an insanely strong currency, who could suddenly enjoy the fruits of an incredibly weak currency (versus the dollar), even as they sell their high end goods into mature developed world markets. DXJ is a way to play this.

Then too, Shinzo Abe, Japan's Prime Minister and the author of "Abenomics," has to think hard on how to save the entire Japanese economy from deflation. This is no easy thing, as Japan has been working off its own deflationary malaise after a capex bust with decades of fallout (ahem, China, cough). As such, Abe may wind up strong-arming his allies at the BOJ (Bank of Japan) to weaken the yen further… which would help Japan's exporters in the same manner a giant shot of steroids could help a racehorse (though the medicine itself is meant to be administered to Japan's entire economy).

Japanese equities in general also have the benefit of highly compressed valuations due to historic corporate bloat. Any real sign that fat is being trimmed, and waste at home being cut to better match lean-and-mean exporting practices, could portend renewed bull sentiment for the entire market. If and when the yen gets back to the business of weakening, perhaps dramatically, DXJ could be a very attractive long.