

Money, Macro & Markets

If you wish to understand why bond yields remain so low, and why the hunger for earning assets is outstripping the modest recuperation in the economy, we only have to note that last quarter's monster net US Treasury issuance was no less than 95% monetized – almost one half by the Fed; 8% by the broker-dealers (who are usually net short through their trading activities but who now have greater access to Fed facilities to fund a free yield-curve play); 5% by US commercial banks, and more than one third by foreign CBs.

Added to this, the demand for credit from the private sector has temporarily evaporated. For example, over-stretched households spent the Spring paying down record consumer credit, as well as redeeming (or defaulting on) more mortgages than they took out for an unheard-of fifth quarter in succession. Non-corporate businesses also paid down a record quantity of obligations, while non-financial corporate borrowings were the lightest since 2004. Partly, this reflects the fact that, rather than rapping their balance sheet both to flatter EPS *and* to pump up the ESOP kitty, the latter actually *issued* net equity (rare indeed, given that they have bought stock back overall in no less than 57 out of the last 62 quarters) and this to a degree only ever beaten once, right at the peak of the Tech Bubble in Q1:2000.

In fact, last quarter, the business sector as a whole disbursed less than \$5 billion a week (pre-tax) in dividends less net equity issues, a bare 2.2% of

personal disposable income and a far cry from the \$37 bln a week (a monster 17.4% of PDI) being paid out for others to spend in the last nine months of 2007 (of which sum more than 80% was effectively then being borrowed). Forget the 'housing ATM' – this was a far more important source of excess consumption during the Boom and it, too, has now been effectively closed to the public.

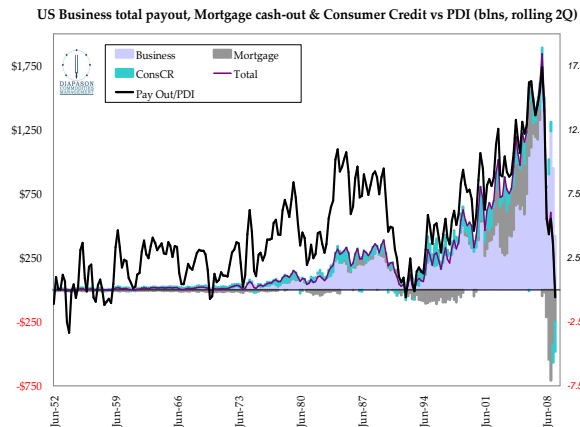


Figure 1: The ATM is empty...

In fact, the combination of retiring or repudiating debt, together with this new-found parsimony on the part of companies has meant households actually suffered a drawdown against personal income in the first six months for only the third time in half a century – very different from 2007's peak, \$900 billion cash-out.

Sadly, despite this very belated attempt at prudence, the simultaneous shrinkage of the economy meant that private sector debt ratios only stabilised, rather than being reduced. Sadder still, the private desire to restore financial soundness

was being totally overwhelmed by a governmental profligacy which led to the state borrowing what amounted to almost *ten times* what the private, non-financial sector has paid back over the last nine months and which, as we noted above, was being financed in a dangerously inflationary manner.

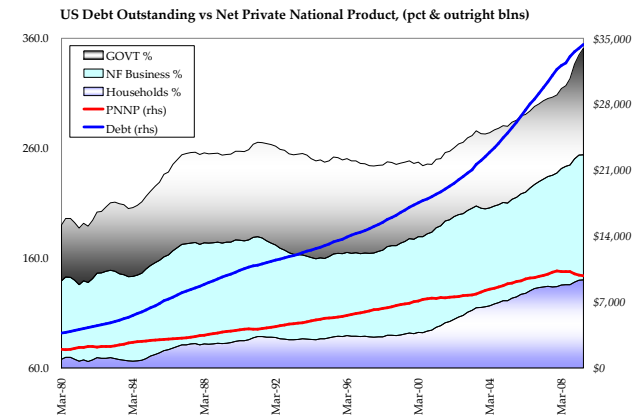


Figure 2: The Red Queen of Debt

2Q Change in US Debt Outstanding & Net Private National Product, (blns)

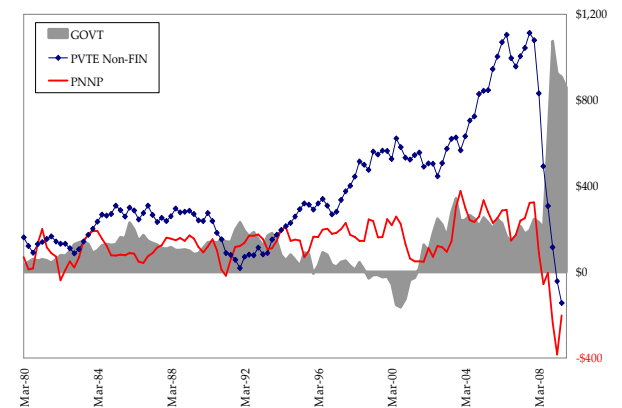


Figure 3: The State v the People

Partly reflecting this, the US current account may have halved as credit-fuelled trade flows have contracted, but the whole amount (and more) was being financed last quarter by foreign official money, which implies that the process of closing the gap is now fully reserve-status dependent.

Perhaps the most worrisome of all these trends is that 2009 has marked yet another nadir in the forty year trend to lower net business investment in the US. Given that the future production out of which the state must hope to recoup its gargantuan current outlays is unlikely to grow in the absence of such investment, as well as the fact that a greater per capita quota of capital is a *sine qua non* of higher real wages for all, the fact that this fell into the red for the first time in a 57-year statistical record must give America's army of indefatigable cheerleaders serious pause for thought.

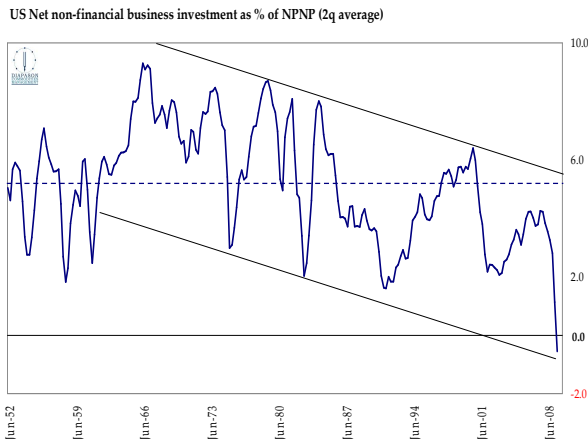


Figure 4: Burning down Tomorrow

Commodity Corner

Though we talk blithely about the ‘structure of production’, the visualization of this as an ordered, expanding triangle or cone along which we move smoothly and predictably from specialized machinery and raw materials through to shop-front ‘merchandise’ is a highly misleading one. In truth the topology is highly complex with any number of feedbacks and extremely contingent loops of supply and demand. The sad fact is that the entrepreneur often does not know exactly where he is on that surface, even if he realizes that it exists in a radically different form to the crayoned-in consumer determinism of the Keynesians.

As a case in point take the experience of that backbone of the recent world Boom, Caterpillar. Without wishing at all to single him out for personal criticism, it is nonetheless instructive to read the soundbites which accompanied the firm’s successive quarterly releases as the world turned from yet another New Era peak of blue-sky folly, to yet another sour New Deal of reality denial.

In QII’08 - just before the peak, but when thunderclouds were clearly to be seen on every quarter of the horizon – CEO Jim Owens was still waxing enthusiastic, telling investors:

“Never in my 35 plus years with the company have I seen Caterpillar do so well in the face of such a difficult economic climate in the United States. We are on track to deliver our fifth straight year of record profits... for many of our products, supply is very tight, and we are producing as much as we can. That’s why in June we

announced capacity expansions in the United States, China and India. We need to bring additional capacity on line to support world demand for infrastructure, energy and mining, and to be prepared for the upturn in the United States when it comes.” [all bold text, our emphasis]

Mid-way through October, a full month after the AIG-Lehman debacle had unleashed panic in currency, commodity, and credit markets everywhere, he was still resolutely sanguine, assuring his audience that:

“We are pleased to have set a new third-quarter sales and revenues record... Demand in emerging markets and commodity prices at levels that encourage investment in mining and energy have helped offset negative economic conditions in much of the developed world... Our current outlook for 2009 calls for sales and revenues to be about flat with our full-year 2008 results.”

Alas, the fourth quarter turned out to be a touch more difficult than that and Mr. Owens responded by admitting that:-

“Through the first three quarters we experienced booming demand from key global industries, notably mining and energy, and most emerging market countries. Delivery times for many products were extended, and we were focused on increasing production and expediting shipments to meet customer needs - Then we were whipsawed... as key industries were hit by a rapidly deteriorating global economy and plunging commodity prices...”

Last quarter, though a measure of profitability had been restored by rigorous cost-cutting, after making a rare loss in the first part of the year, Mr Owen summed up as follows:-

“Team Caterpillar is now halfway through one of the most challenging years in the company’s history... The worst economy since the 1930s... a serious challenge for capital intensive manufacturers... Our 2009 sales have been hurt by weak end-user demand and significant reductions in dealer inventory. In fact, dealers have reduced their machine inventories by about \$1.5 billion through the first half of the year and could reach close to \$3 billion by year-end.”

Indeed, far from ‘flat revenues’, the company’s unofficial monthly machinery sales tally shows the three months to August were running a hefty 33% below year-prior levels in the much-vaunted, ‘decoupled’ Asian-Pacific region and no less than 48% lower worldwide.

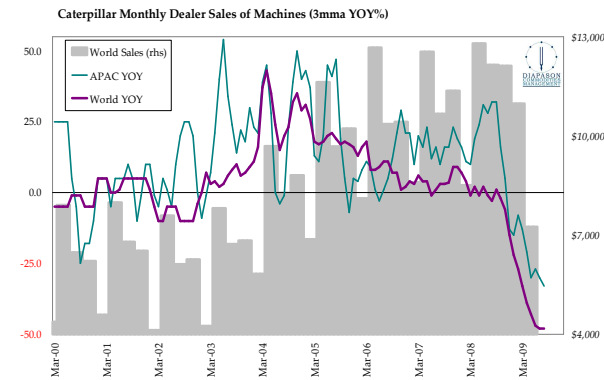


Figure 5: CAT - In a hole, but still digging

To reiterate, none of this is to impugn Mr. Owen’s skill as a business leader, nor to question the excellence of his company. It does serve, however, to underline that the Clausewitzian fog, in the midst of which multi-billion dollar, real-world decisions must be made, can be well nigh impenetrable - especially to those oblivious to the dangerous instabilities of the world financial system or who have been bamboozled by the siren calls of false optimism routinely issued (on a scale of sharply increasing culpability) by avid stock promoters, self-serving banking chiefs, political axe-grinders, and ivory-tower, central-bank money manipulators.

What does all this imply for our markets? Simply that they are tired and – if the erratic option prices of the past few days are a guide – nervous, too. US monetary expansion seems to be decelerating. The Shanghai Comp has seemingly rolled over and is possibly ripe for another deep swoon. Freight and tanker rates are softening. The DCI in dollar-adjusted terms is also at something of a watershed. Time for some long overdue caution, perhaps?

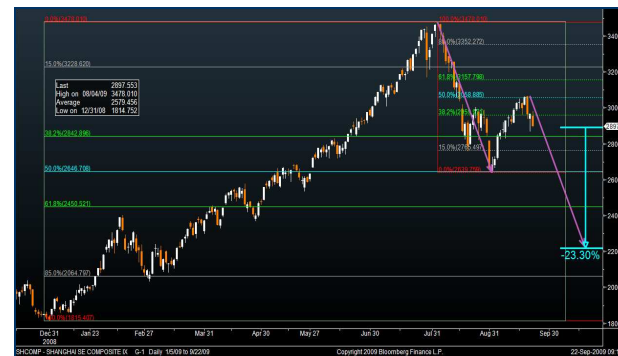


Figure 6: Bear in a China shop?

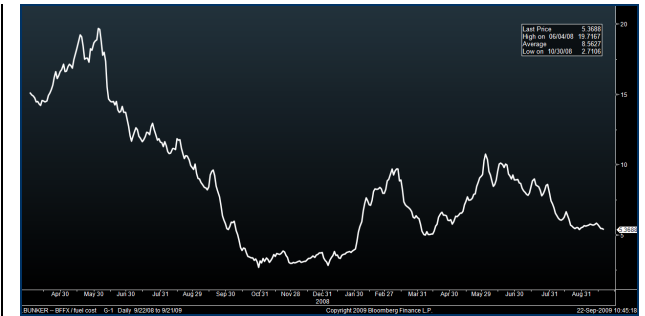


Figure 7: All at sea – fuel cost-adjusted bulk freight



Figure 8: DCI x USD TWI – at a crossroads?

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