

Hoping for the best, preparing for the worst

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■ ■ Distant relatives?



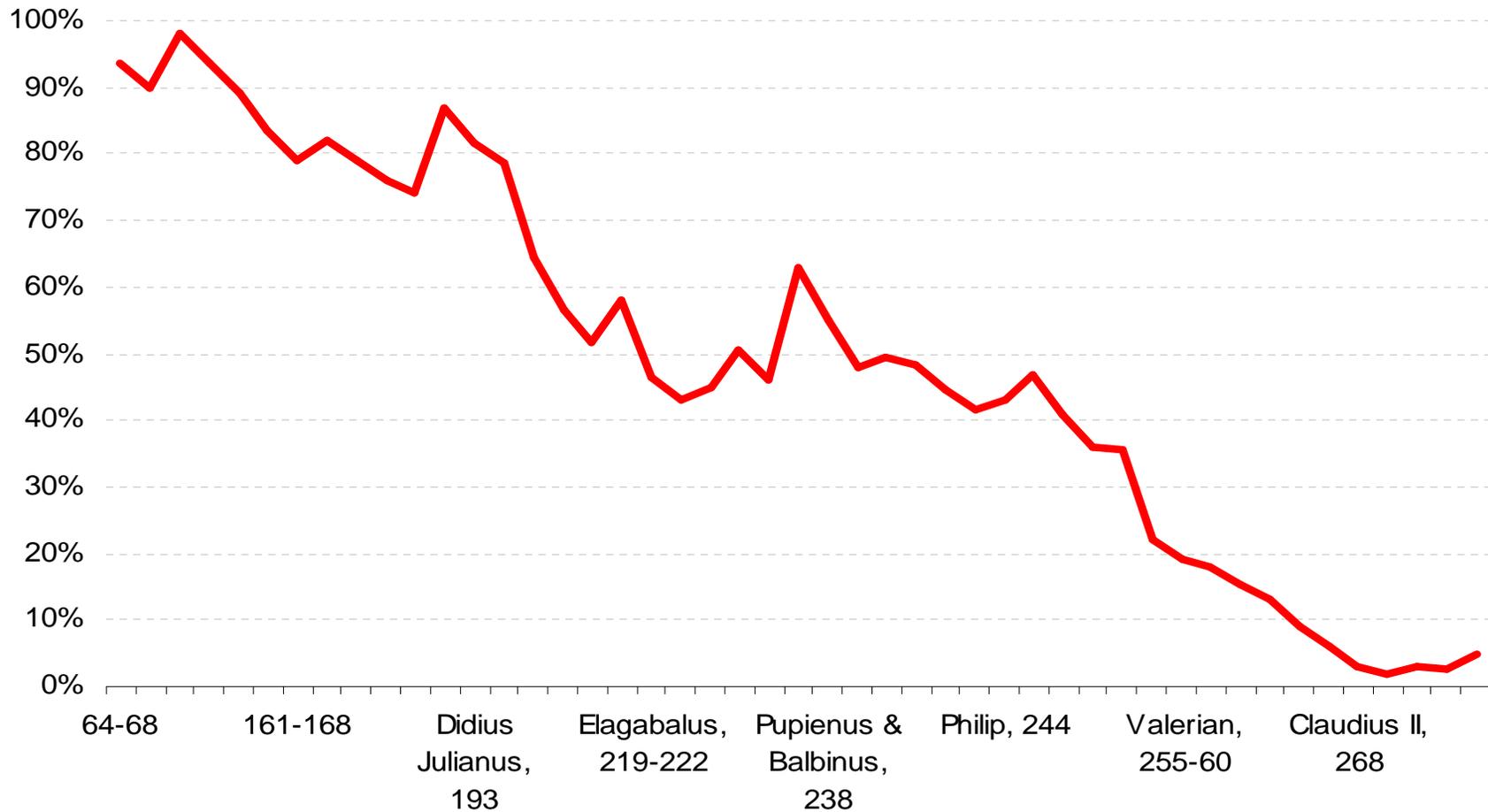
Ben Bernanke, chairman
of the Federal Reserve Board, 2006-



Rudolf von Havenstein, president
of the Reichsbank 1908-1923

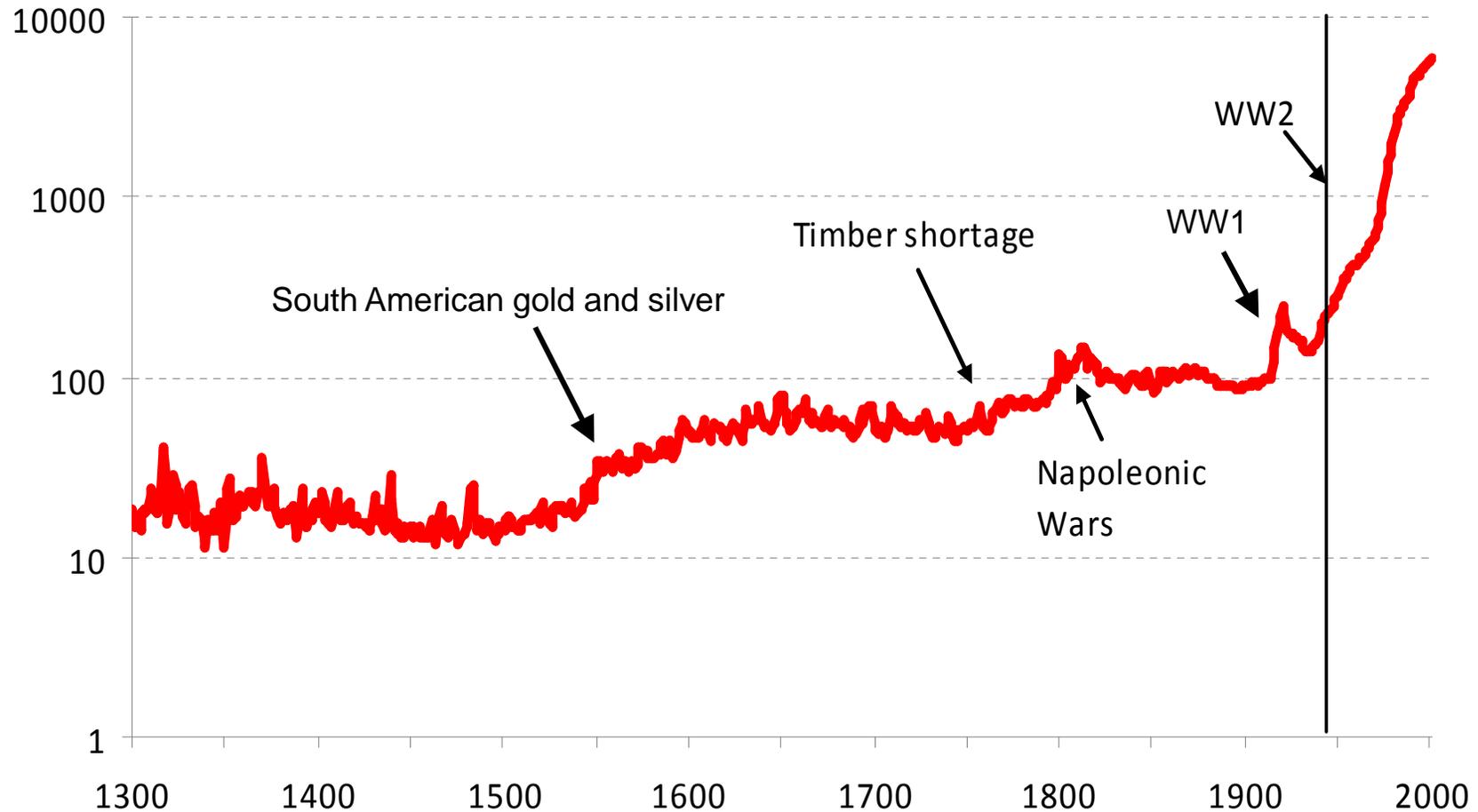


Silver content of Roman coin as Imperial finances became increasingly strained



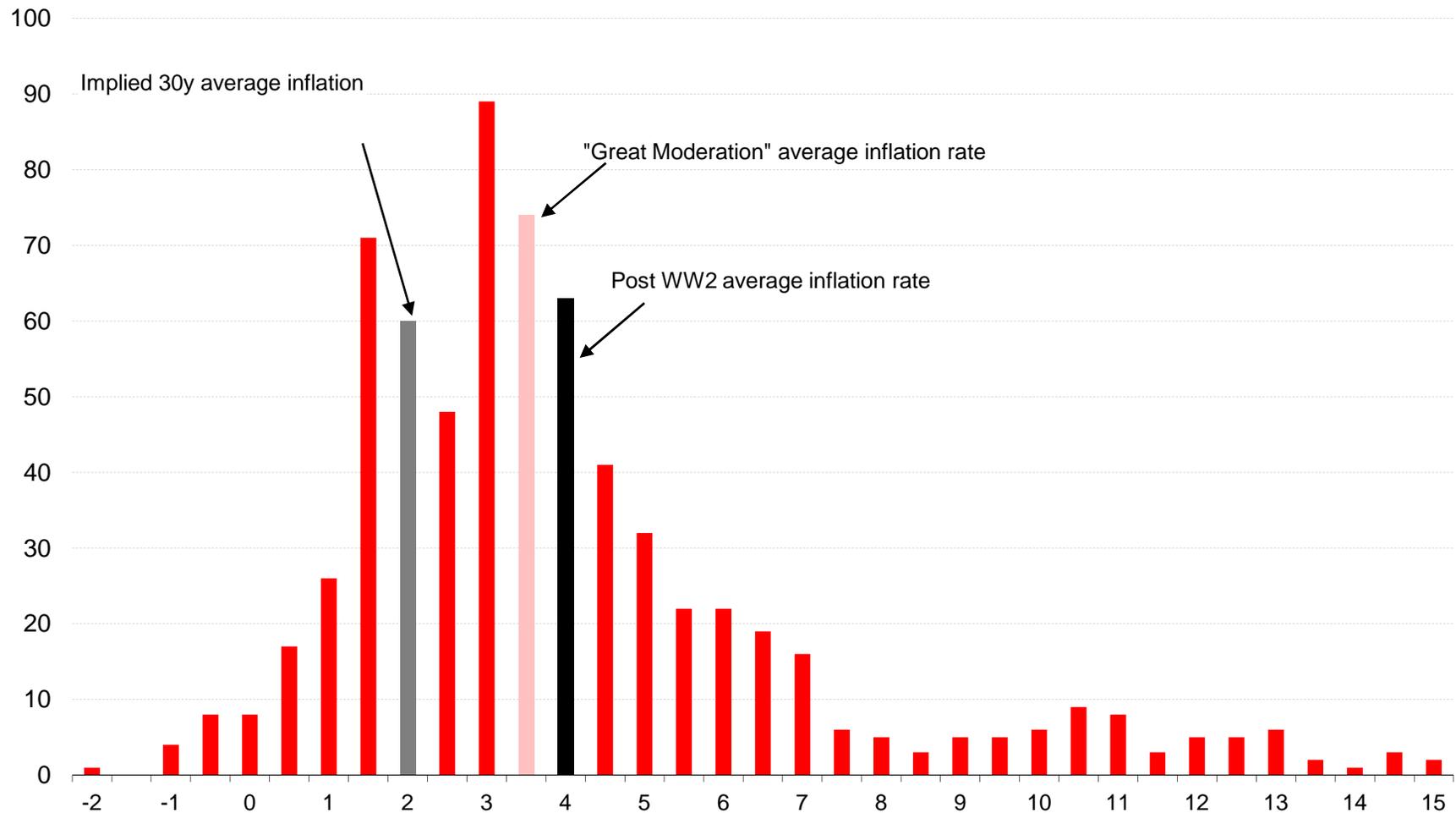


The inflationary bias of policy: UK inflation down the centuries (log of retail price index)



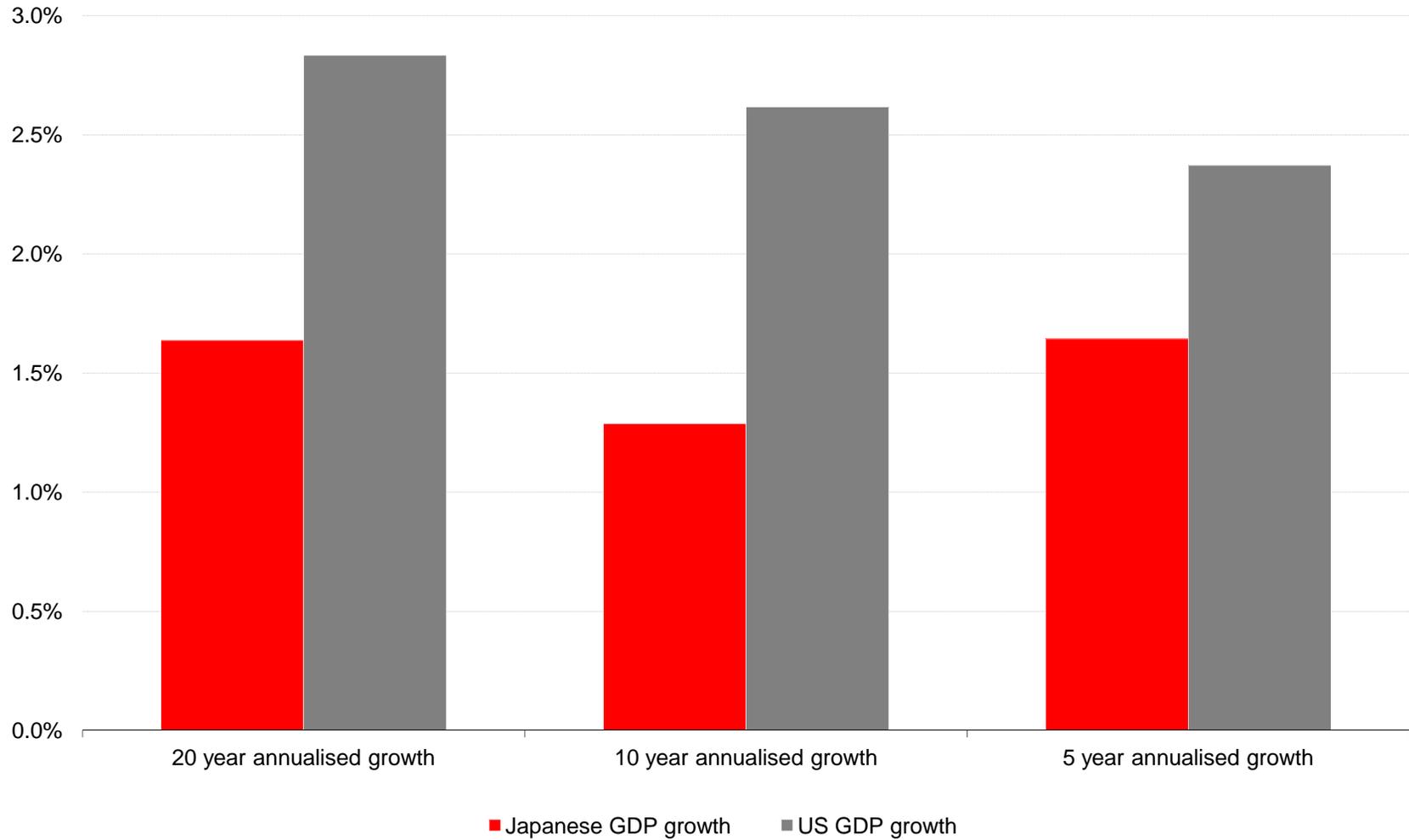


“Deflation is the tail risk here ...” Discuss



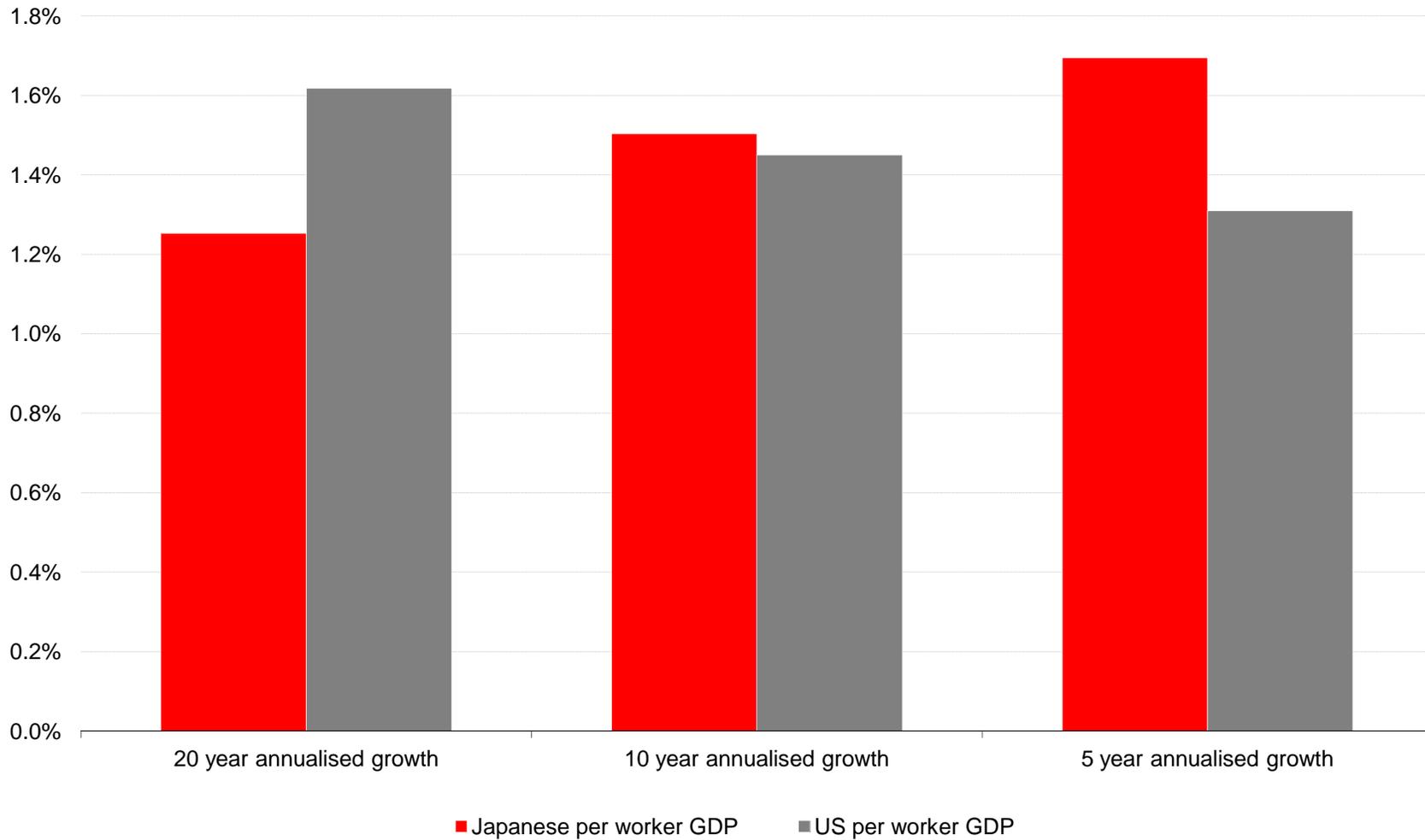


Japanese vs US real GDP growth



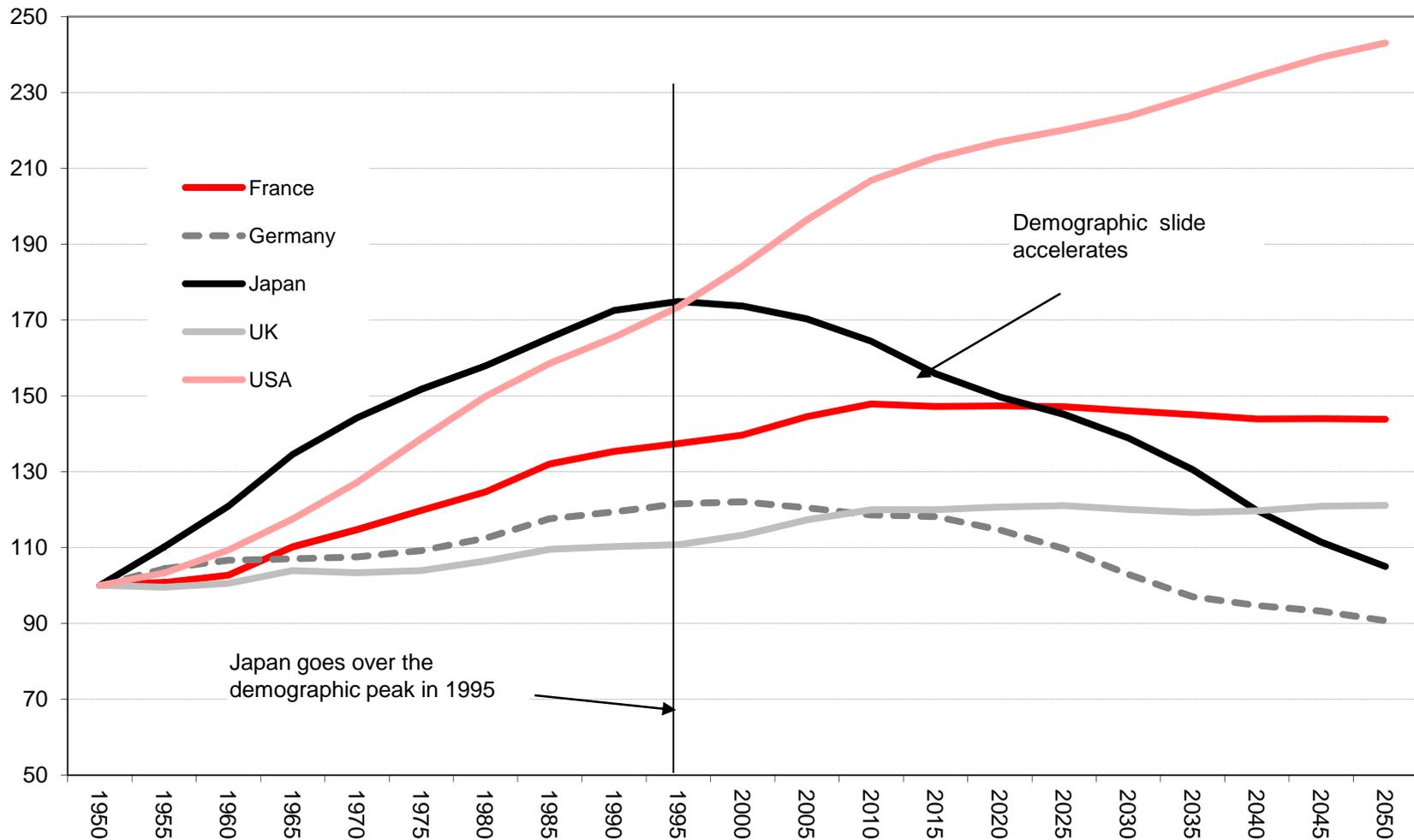


Japanese vs US real *per worker* GDP growth





Working age population projections: Japan seems a special case



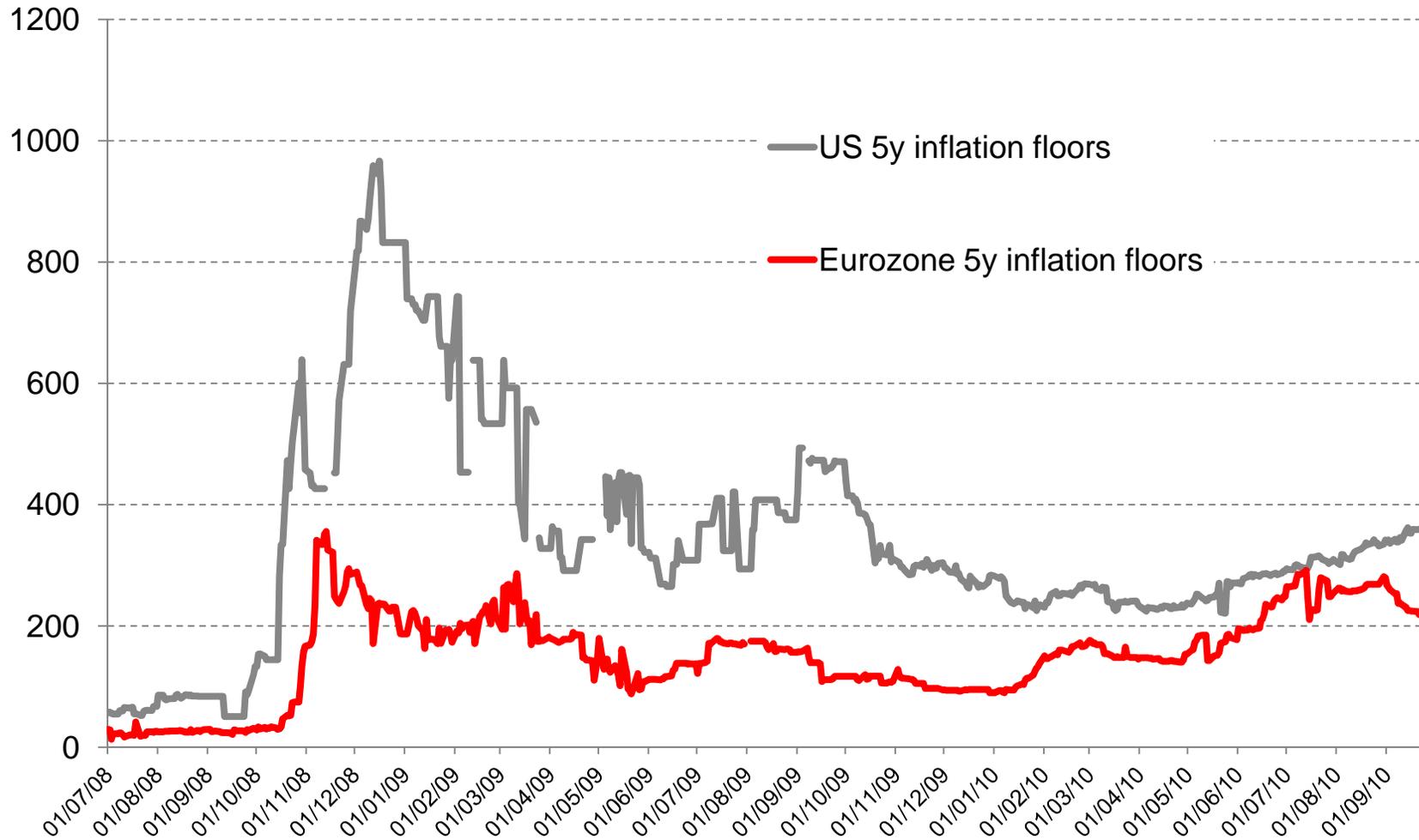


■ The problem of induction: that there have been no debt deflations doesn't mean there can be no debt deflations



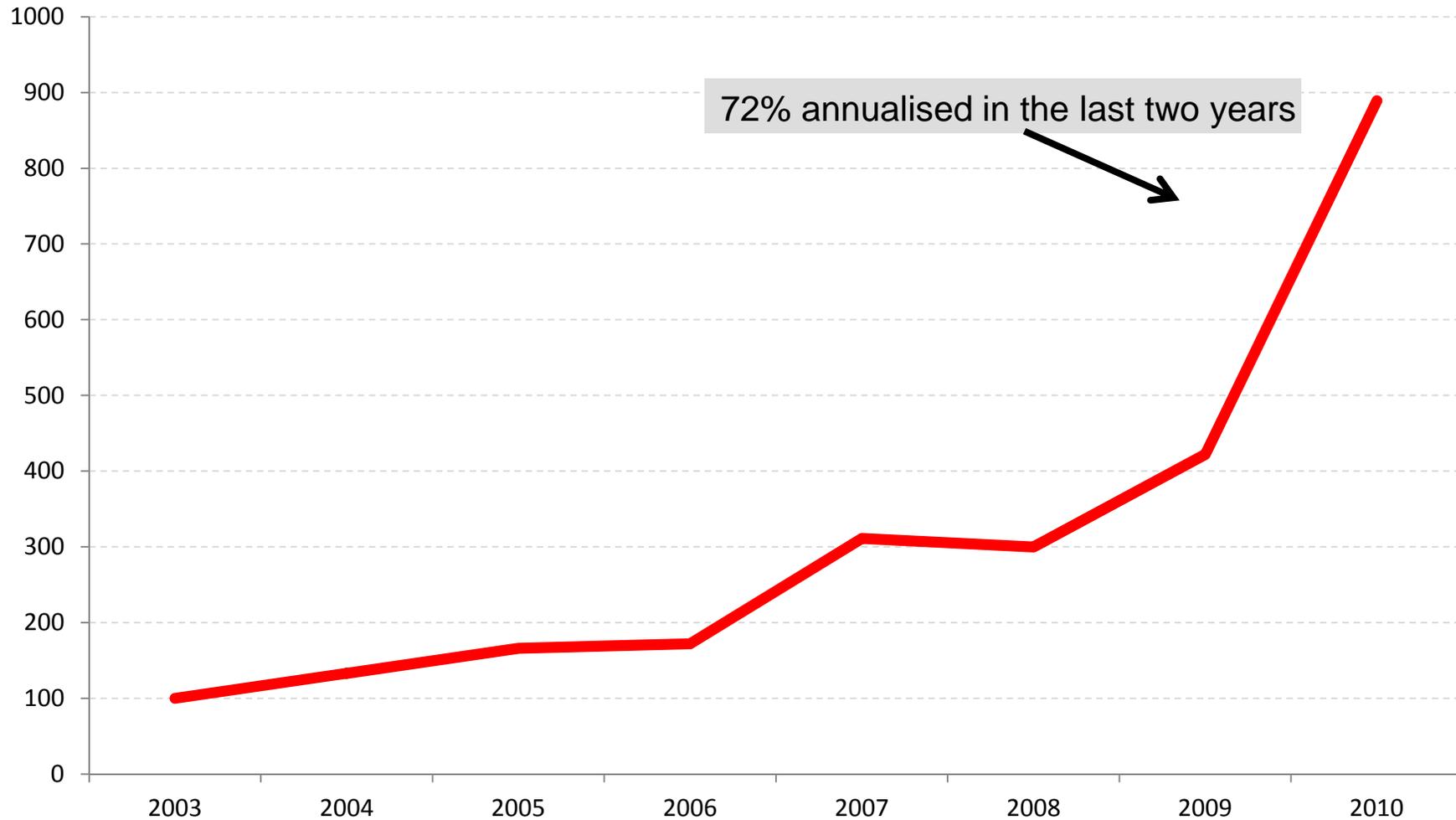


0% inflation floors pricing in *significant* CPI declines over next five years





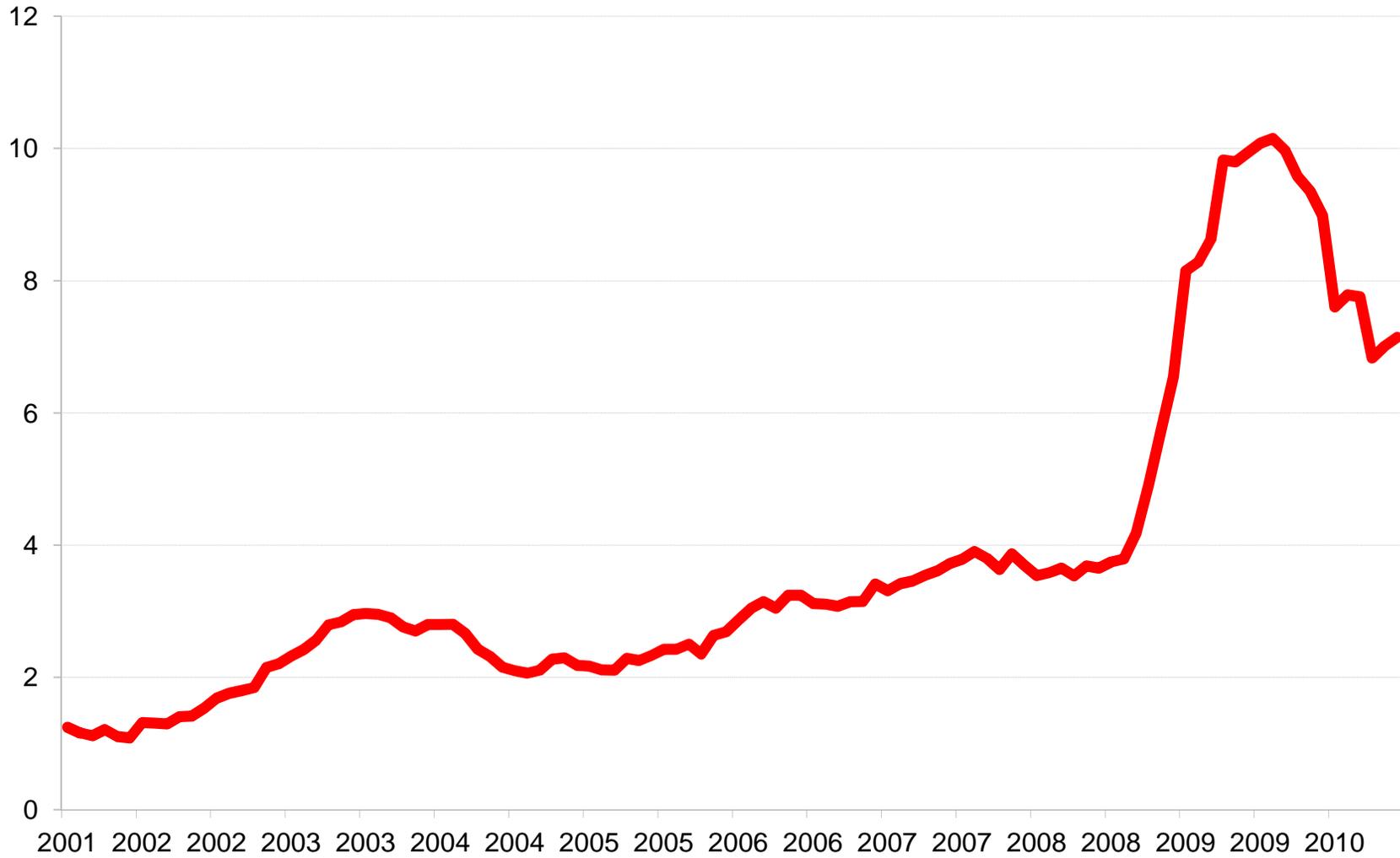
Is the real deflation risk here a Chinese hard landing? Beijing land prices have risen 800% in the last 7 years





The greatest credit inflation in financial history?

trRMB (cum 12m sum)





Expensive insurance? S&P500 6m ATM volatility has been repriced since the crash





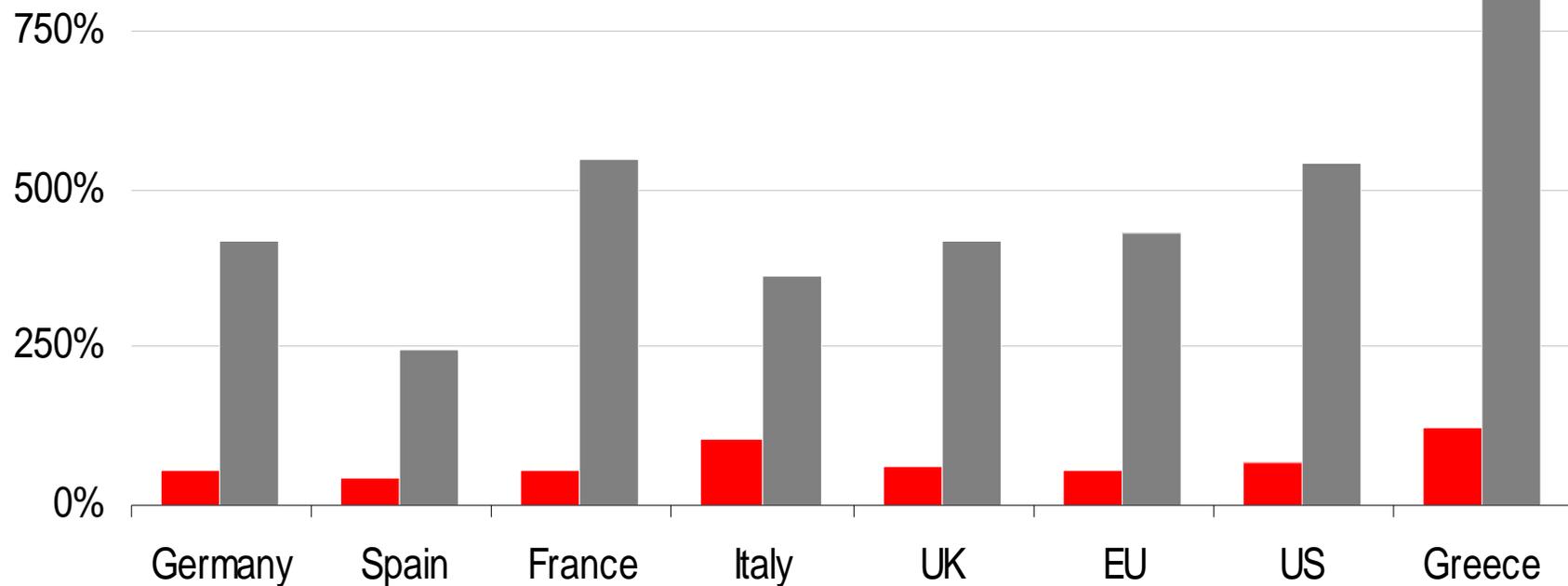
Cheap insurance? Hang Seng volatility well below its long-term average





Our governments are insolvent

■ Official Net Debt, % GDP* ■ Total net liabilities (on and off balance sheet), % GDP**

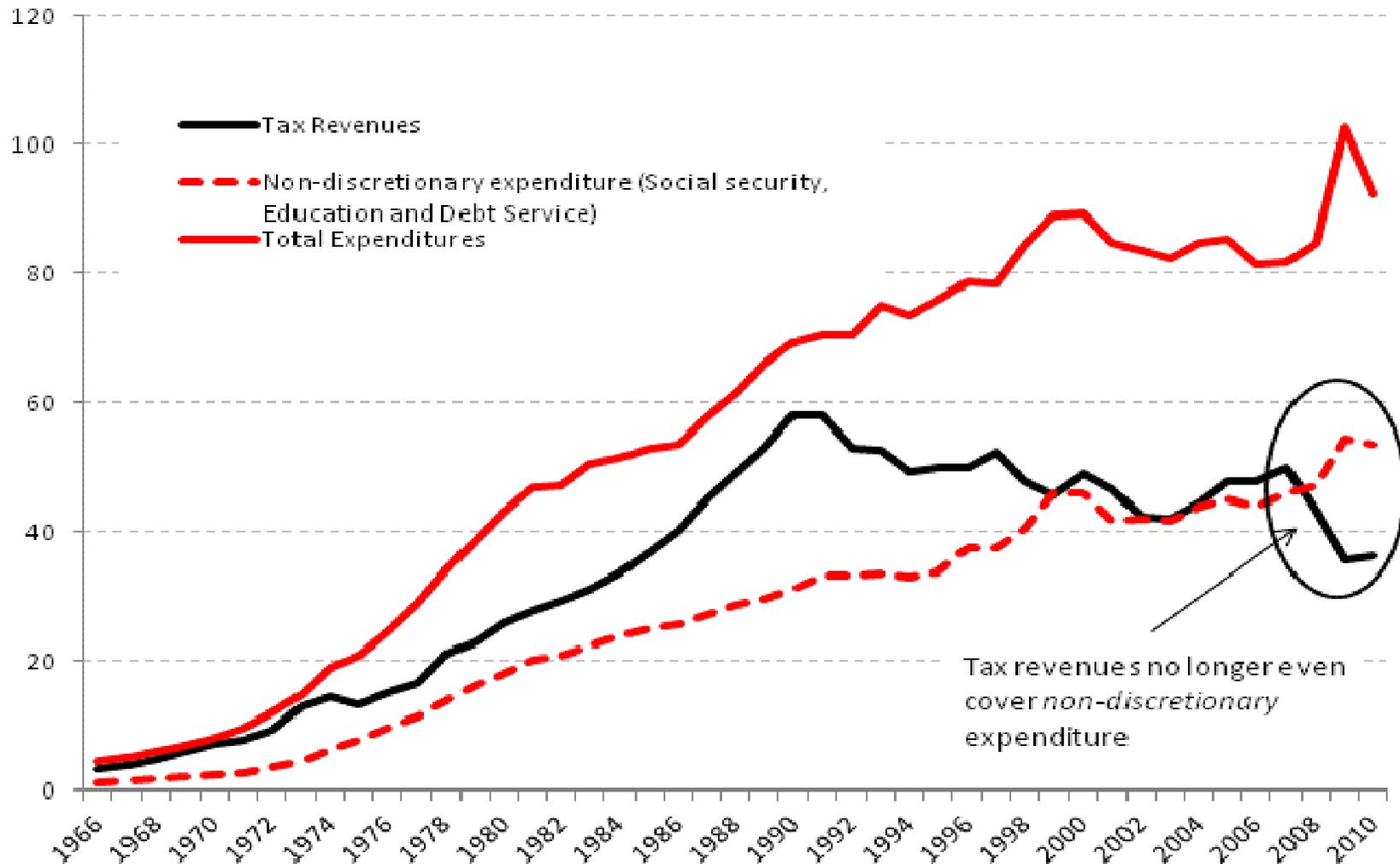


* 2010 OECD projections

** 2005 estimates of total Fiscal Imbalance

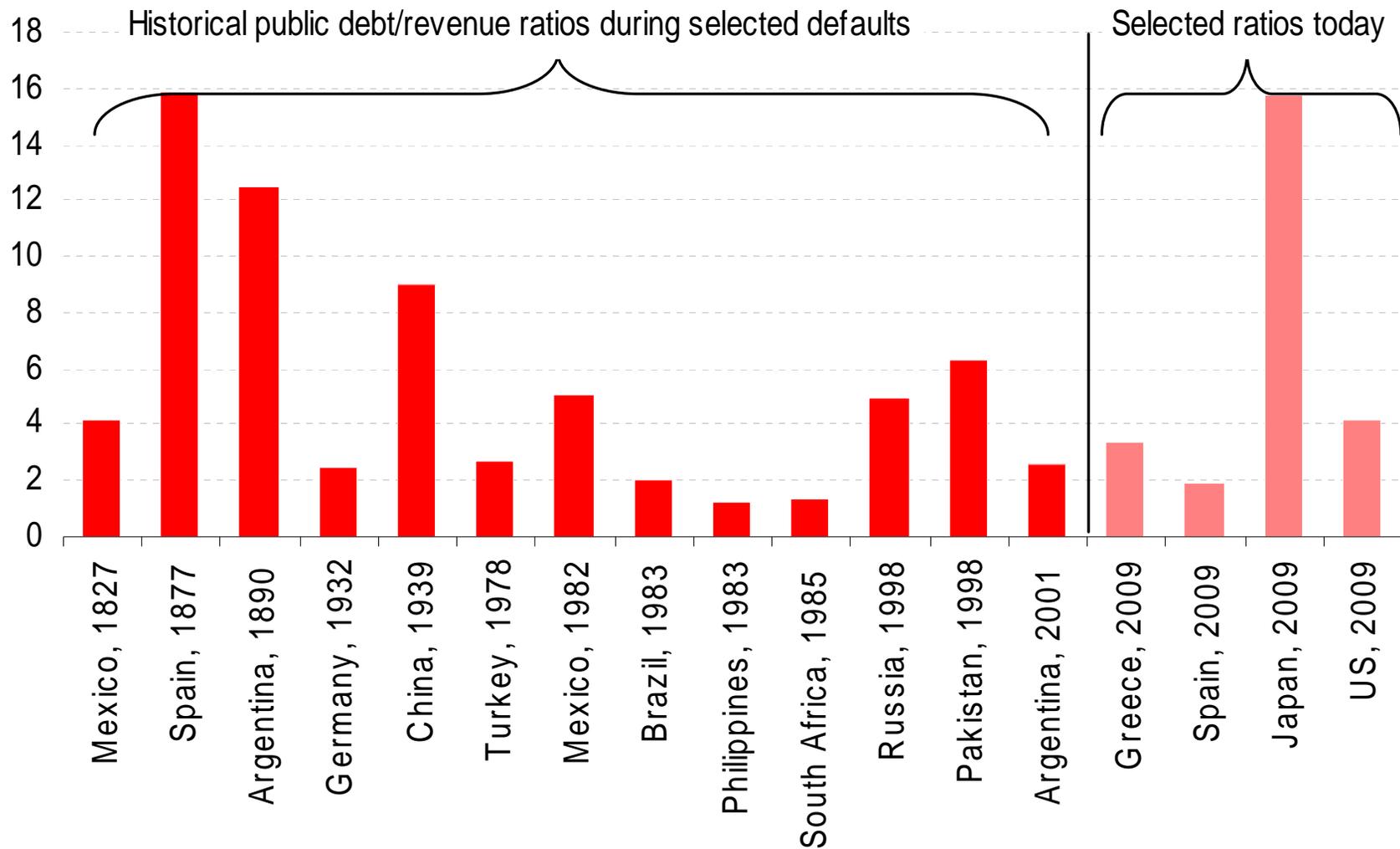


Japanese government tax revenues no longer cover *non-discretionary* expenditure





'If' is easier than 'when' ... There is no debt/revenue ratio crisis 'trigger point'





Cheap insurance? JPY swaption volatility below historic average





Cheap insurance? USD swaption volatility below historic average





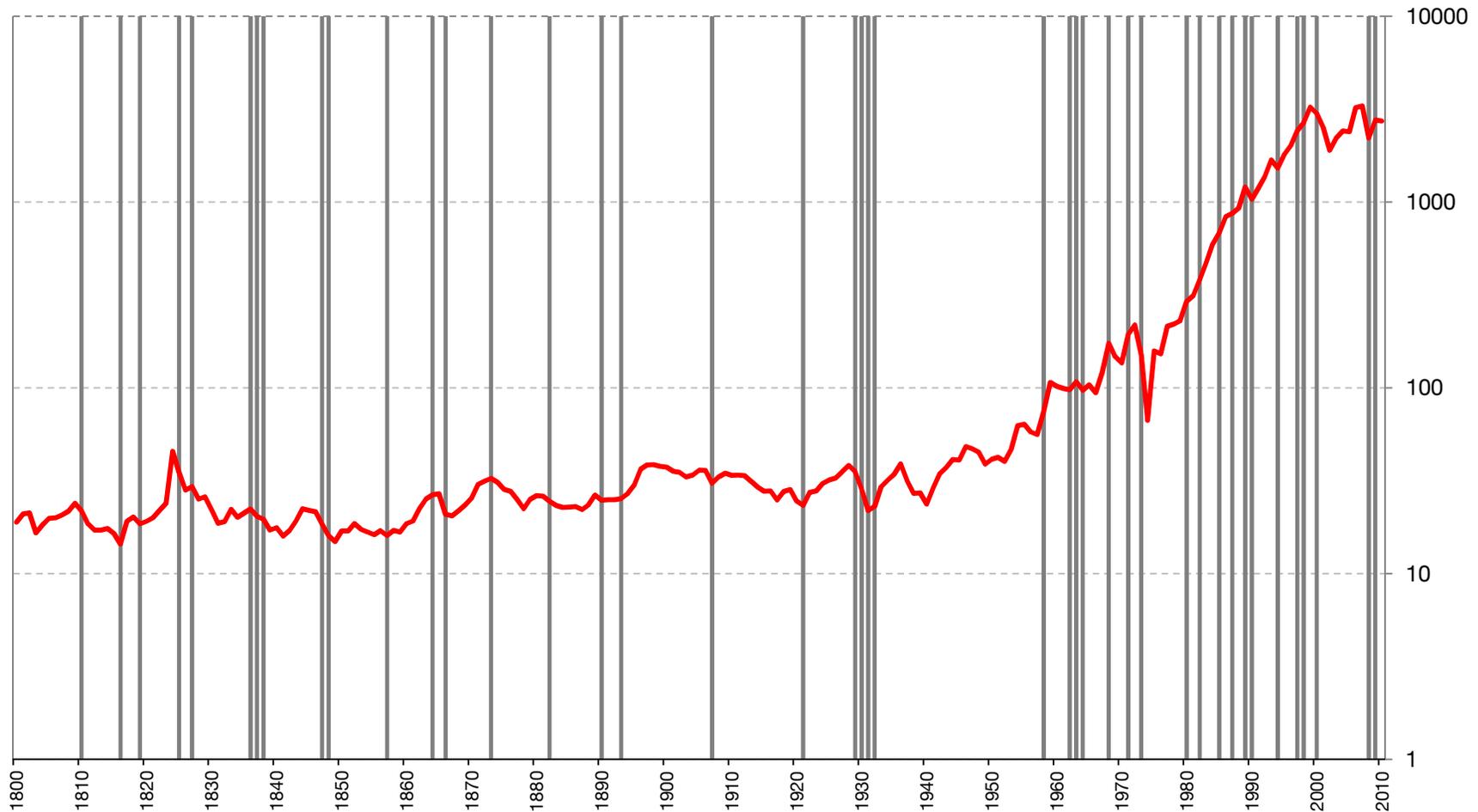
This time is different ... 1914 style

*“ ... there will be no unlimited issue of paper money and its steady depreciation ... **since monetary science is better understood at the present time than in those days.**”*

New York Times on why the war which had just broken out wouldn't be inflationary, Aug 30th 1914



The inflationary bias of policy, or the illusion of control? ...log of FTSE All Share with financial crises (grey bars)



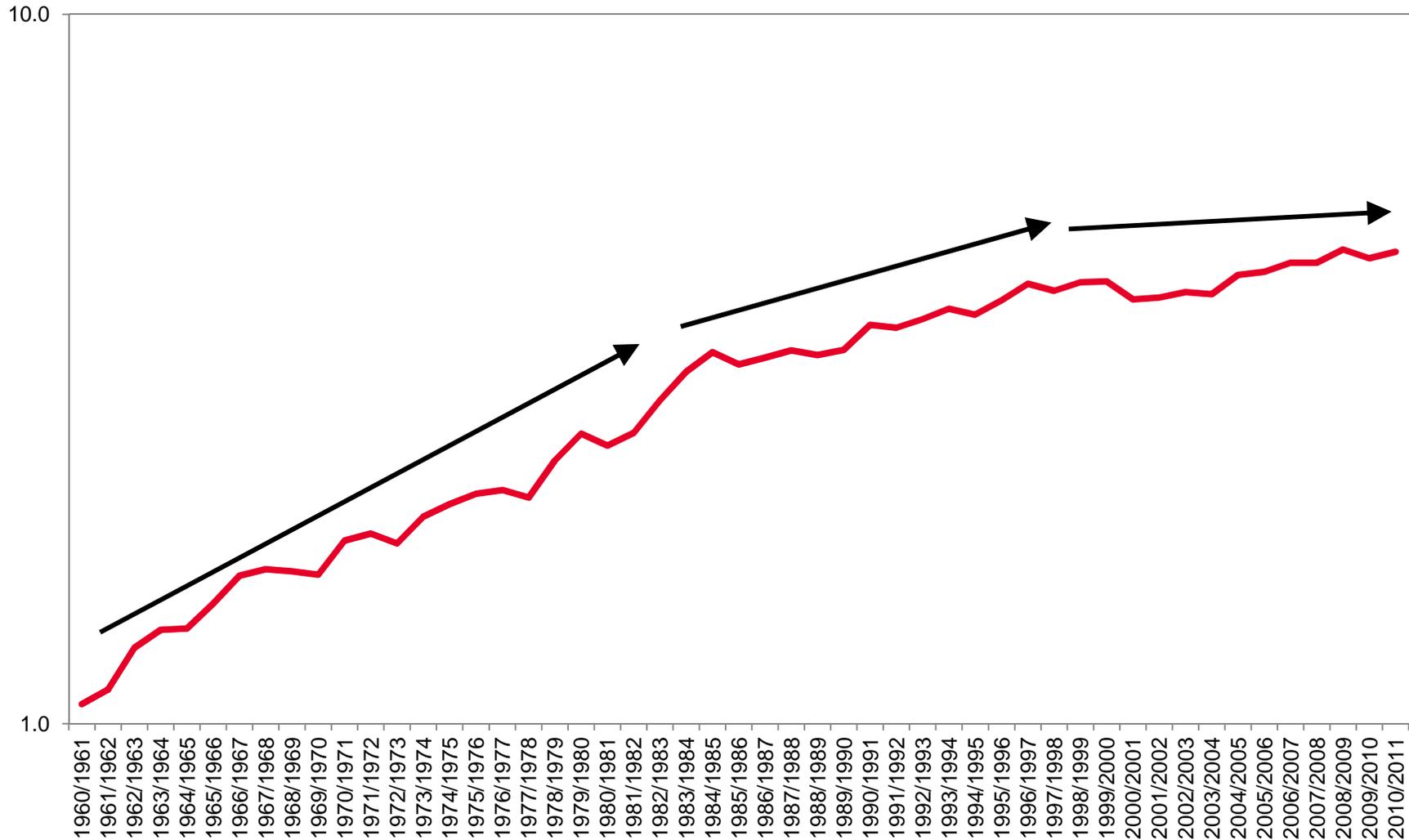


Gold is 'cheap' (% gold backing of US monetary base)



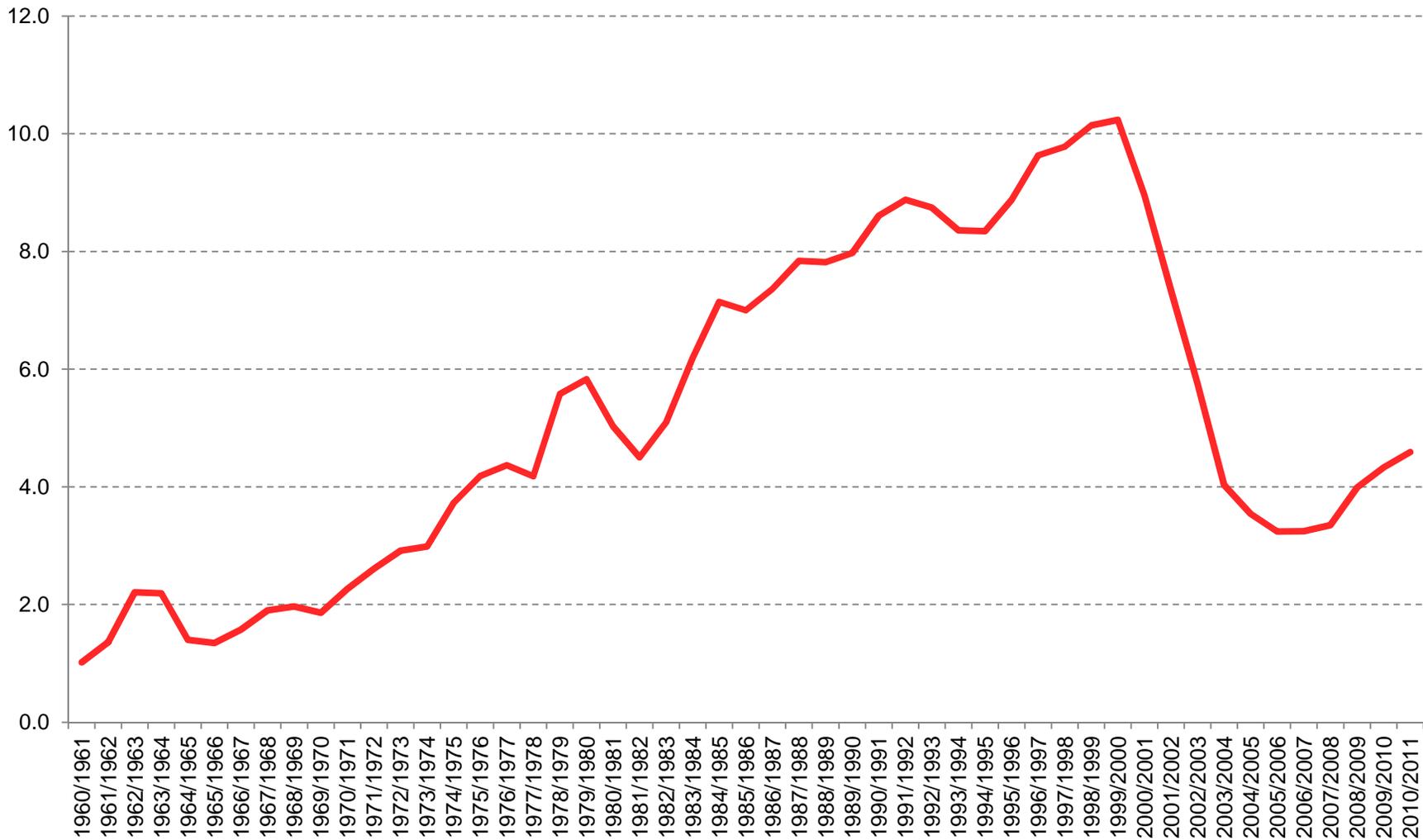


log of Chinese agricultural productivity (tonnes per hectare)



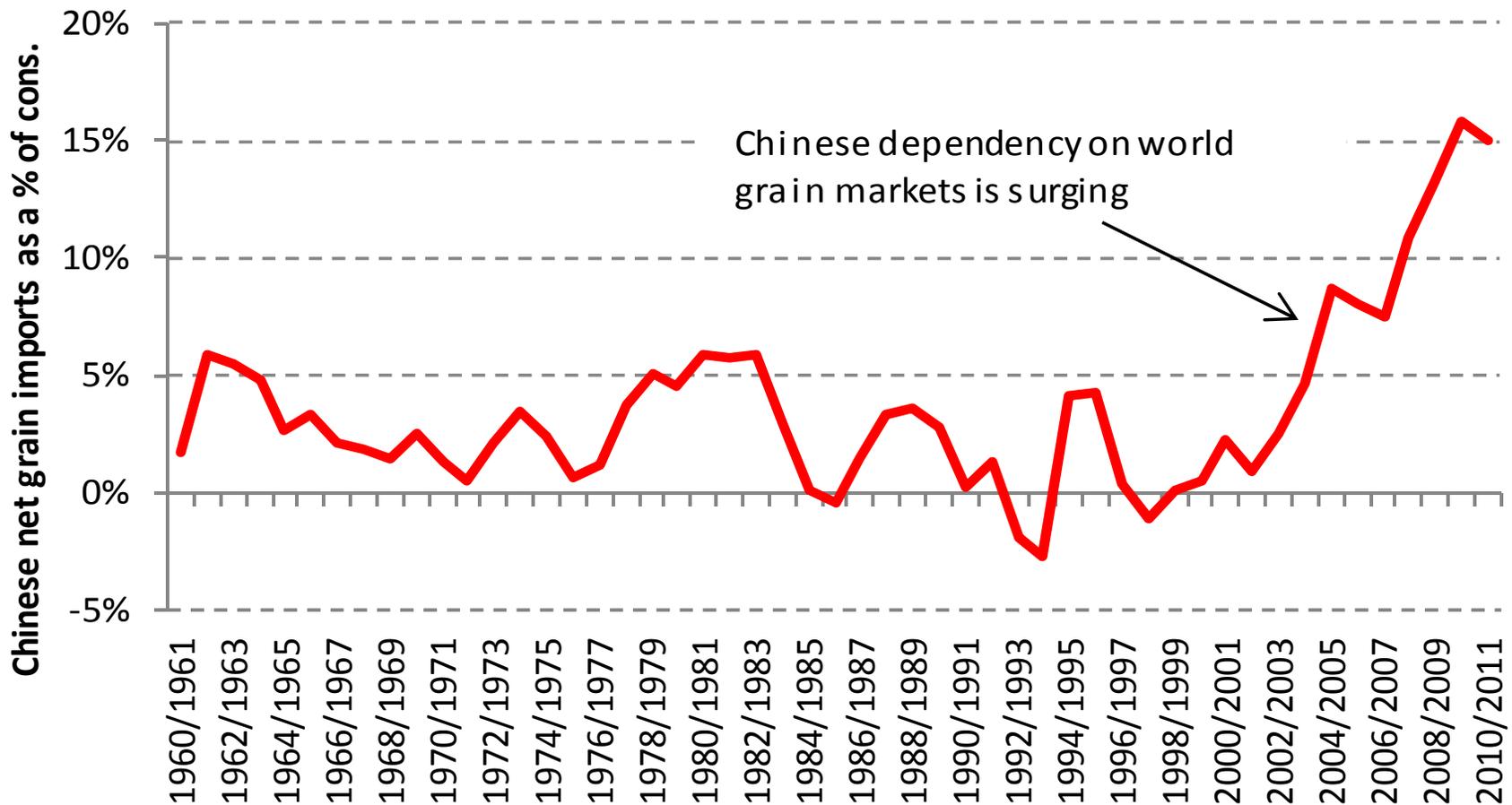


China rebuilding inventories after recent plunge ... (stock to consumption ratio, months supply)



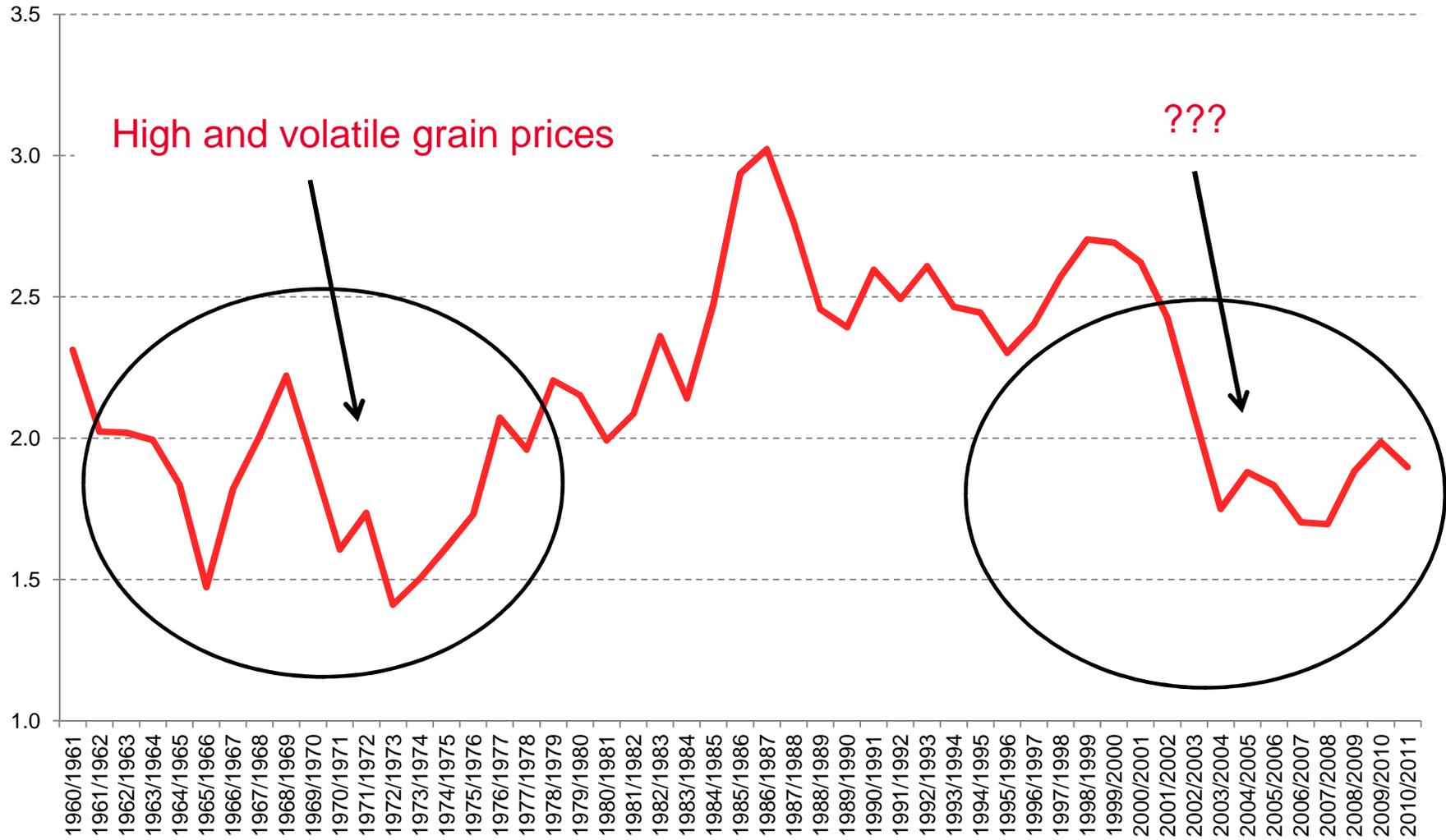


... but through imports rather than production (net grain exports as a % of consumption)



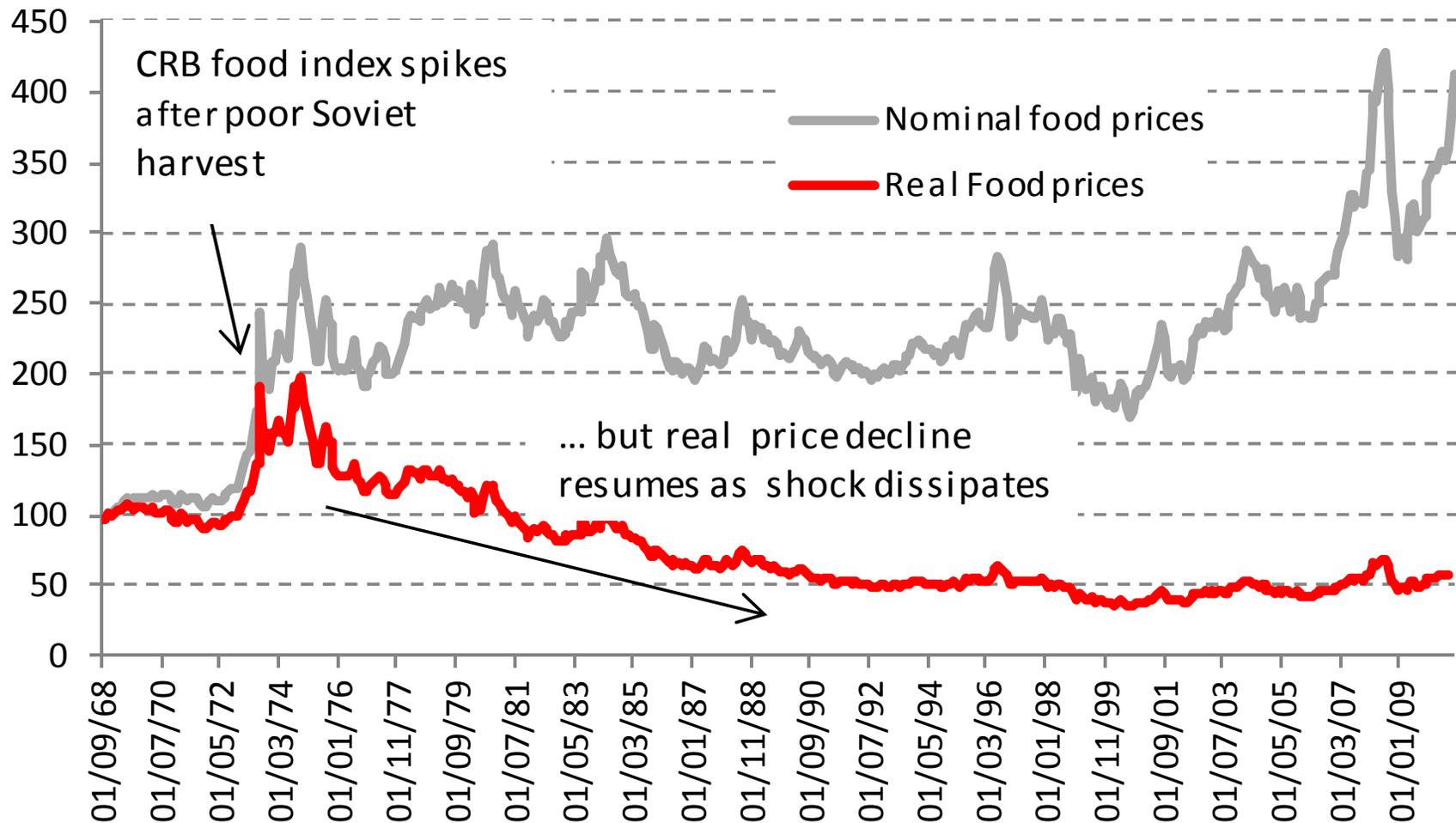


Grain inventories remain historically low; months supply of grains (and soybeans)



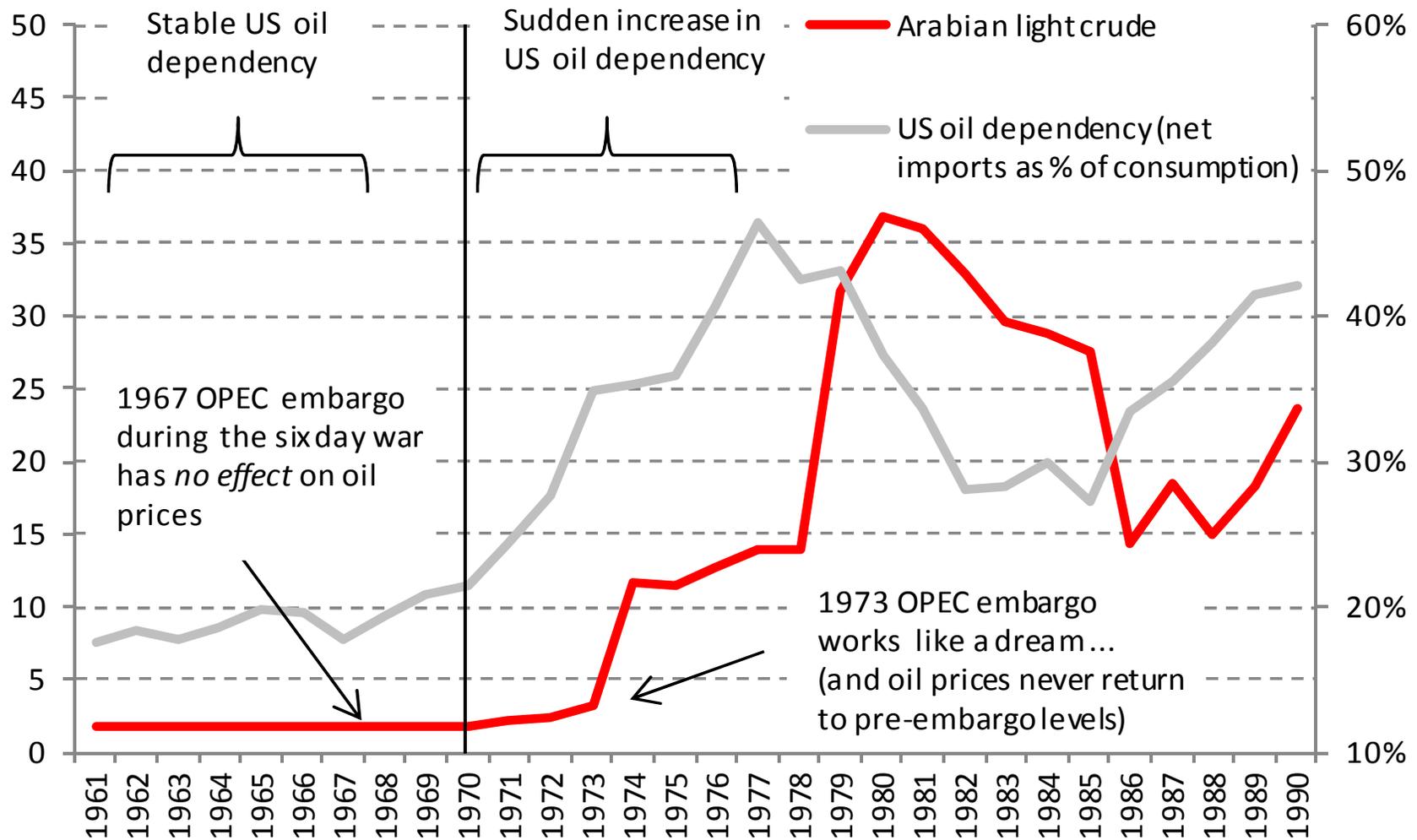


What a temporary shock looks like



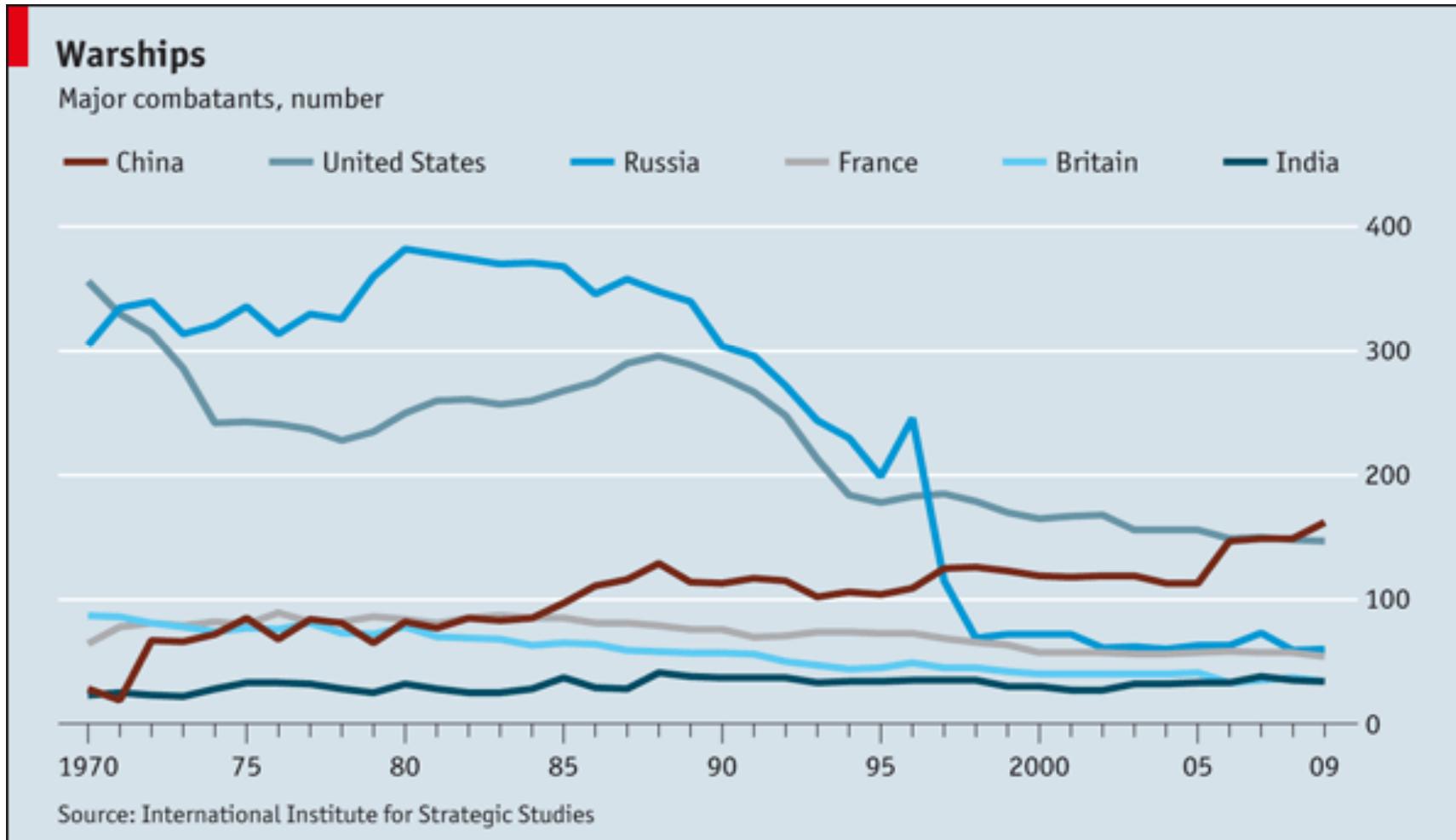


What a permanent shock looks like



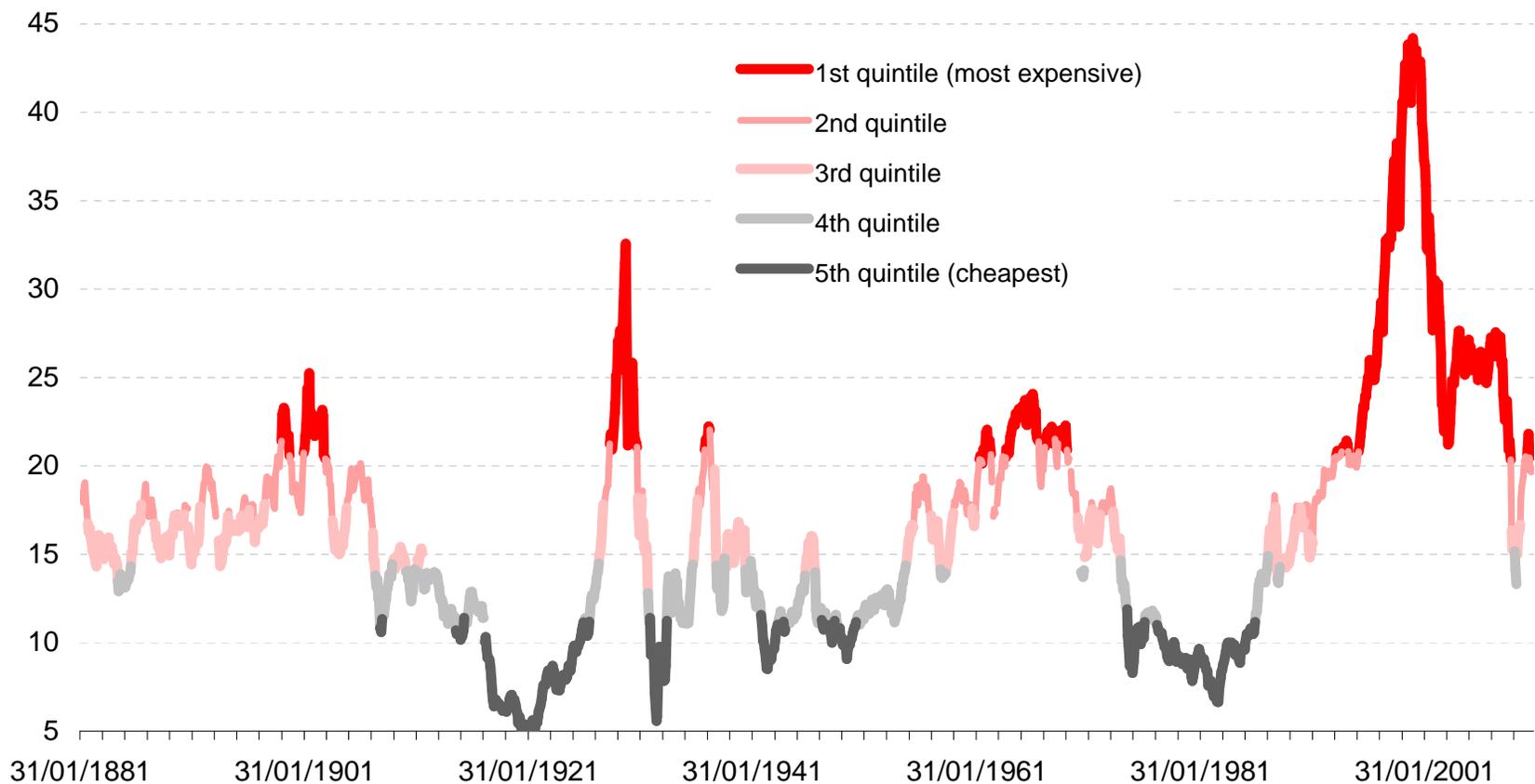


China now has more warships than the US !



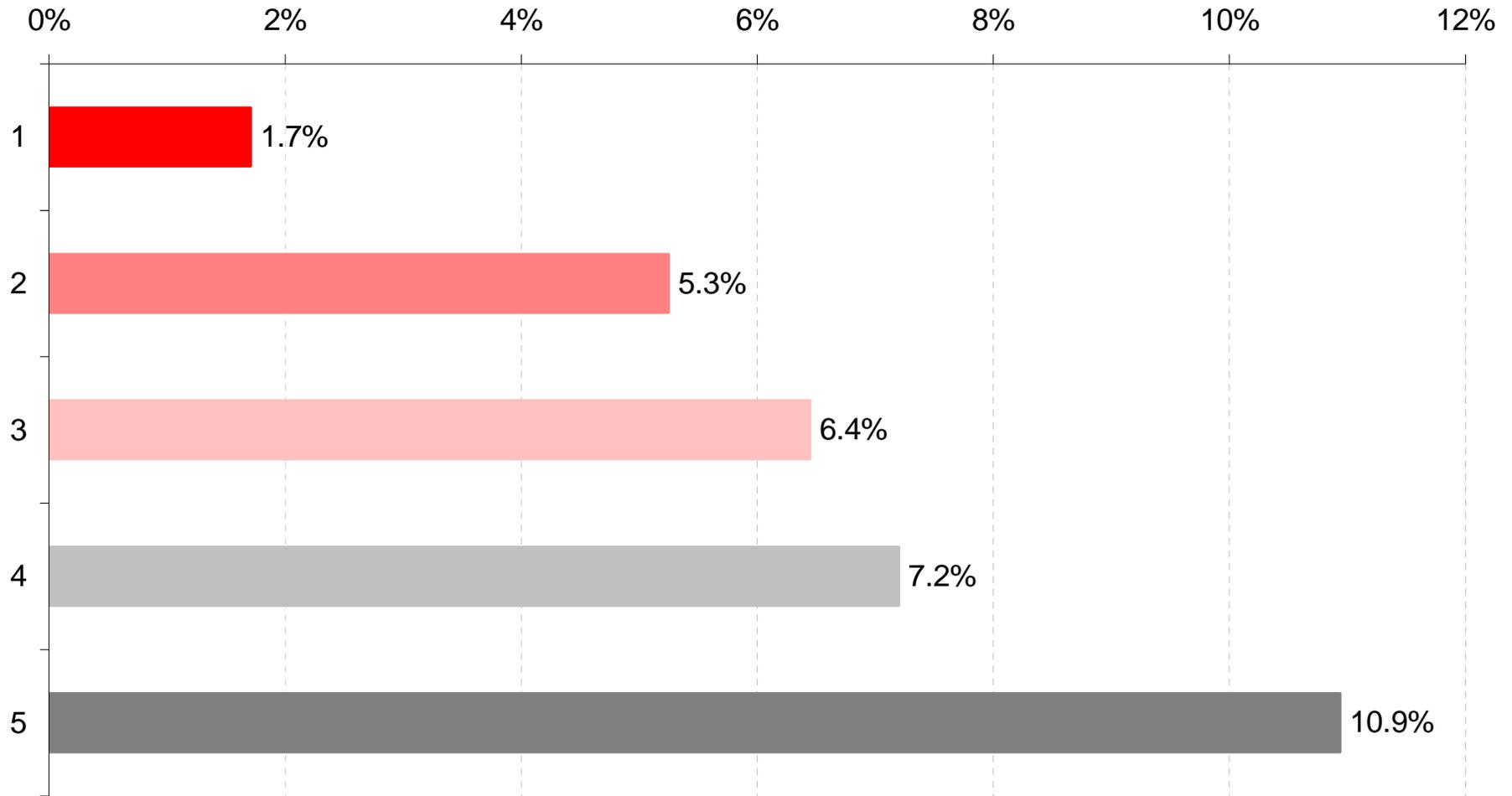


Shiller's cyclically adjusted PE shows the US equities still expensive



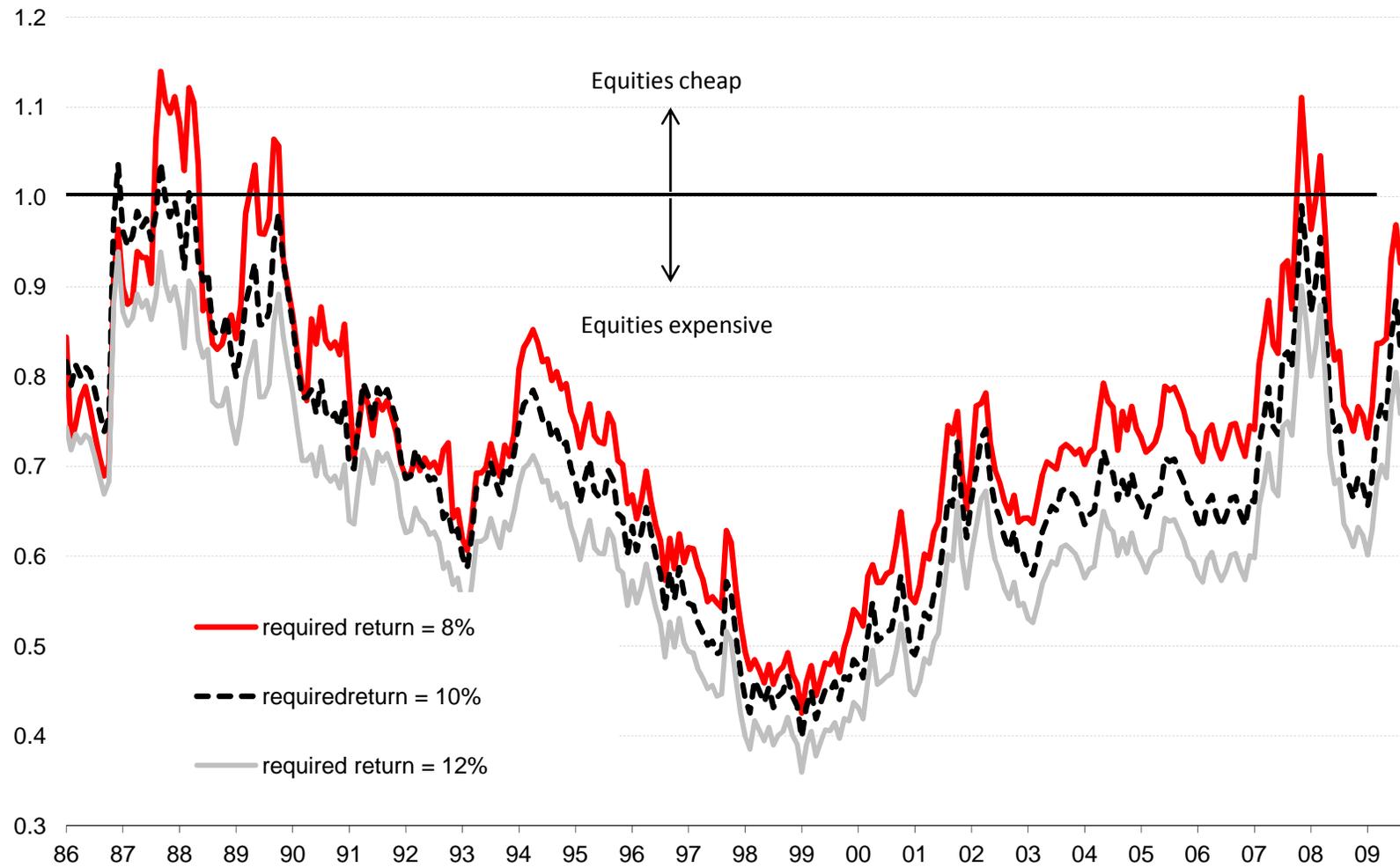


10 year real returns based on the starting Shiller PE





Global IVP ratios suggest equity returns consistent with Shiller-based projected returns



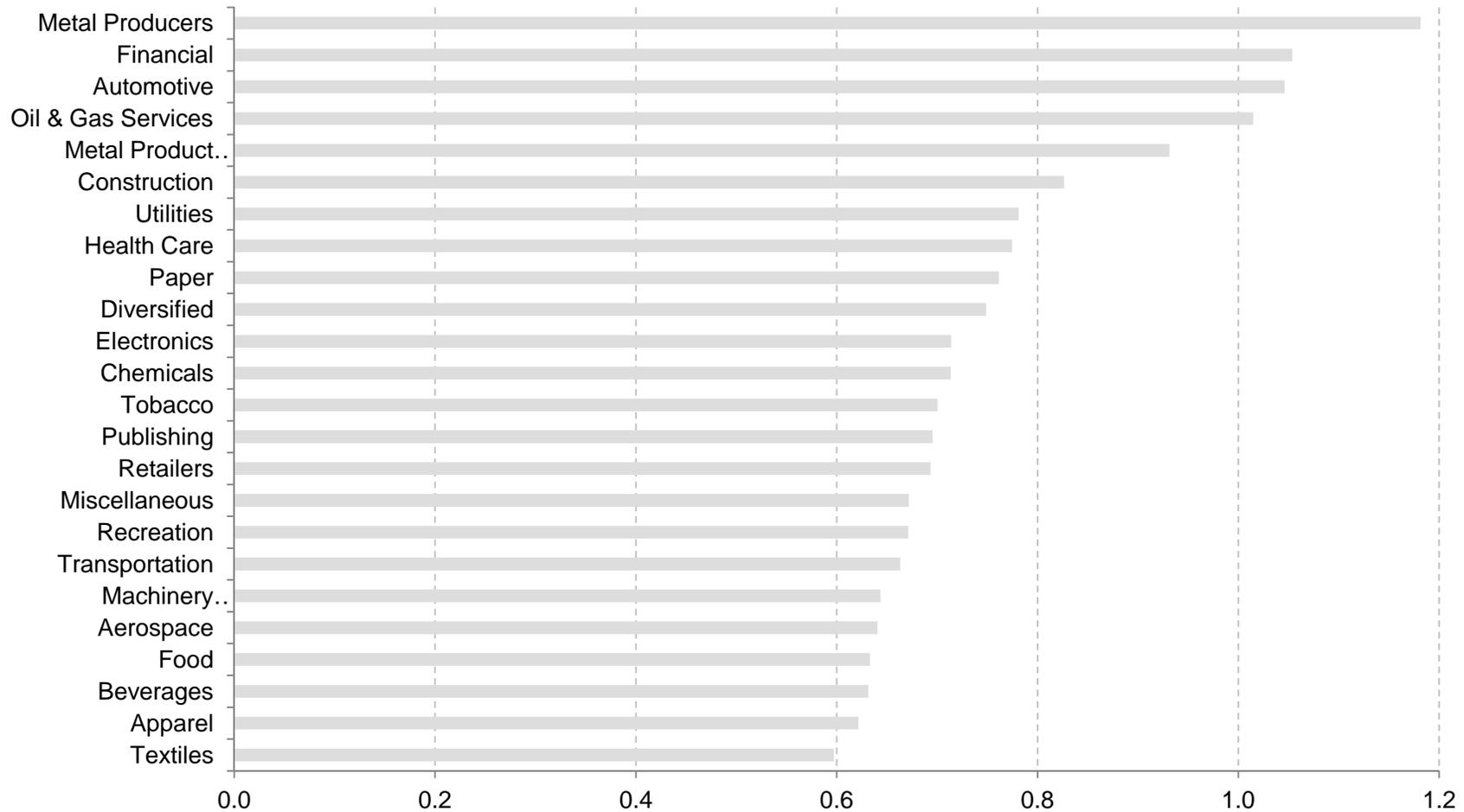


Synthetic long-short returns to buying high IVP, selling low IVP





Sector IVPs (IVP>1 = cheap; assumes 10% required return)





Conclusions:

Hope for the best ...

Pockets of value within equity markets:

- Overall equity markets are consistent with a 5% real return
- Some sectors look cheap
- Well-chosen stocks should be able to deliver more than the 5% on offer from the aggregate market

Some insurance looks expensive enough to sell

- Mid-term developed market equity volatility is rich – sell it on favoured stocks?
- Deflation insurance looks too pessimistic

... prepare for the worst

Scarcity developing in key commodity markets

- Structural shift occurring in grain markets?

Developed market governments are insolvent

- Low swaptions IVs suggest cheap hedge against bond market blow up?

Government balance sheet problems have historically posed inflation risk

- LT upside equity OTMs to hedge

China's credit growth and land price inflation are red-flags

- Downside HSI IVs looks attractive

Is gold the ultimate insurance? (no counterparty default in 6000yrs!)



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