Our Brave New World, Part Two

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By John Mauldin

Is it different this time? Can it be that trade deficits do not matter? Or is our collective debt going to end in a period of financial crisis and tears? Is Alan Greenspan right when he says periods of low risk premiums end in woe for the participants?

For readers in the middle of this conversation, we are in a series on the debate held at a London restaurant between Charles and Louis-Vincent Gave (father and son) and Bill Bonner. The Gaves openly declared that “This time it’s different,” much to Bill’s amusement. We all know that it almost never, ever is. They make their argument in a book called “Our Brave New World.” I did part one of a review two weeks ago and will finish reviewing that book today.

Bill Bonner argues the opposite. He suggests that not only are things not different, that the massive accumulation of debt and fiat currency will end in a financial crisis and a soft depression. He advances his argument in his new book (along with co-author Addison Wiggin) called Empire of Debt. I will begin reviewing his arguments next week. (www.amazon.com/empire)

Then I will share my view on the topic. It will surprise no one that I think the truth is somewhere in the middle. Things are in fact different, yet we will have to find a balance. That a balance and a squaring of the balance sheet may come from new and different forces than in the past will make things seem both different and the same. It is a rhyme, not a repeat. It is Muddle Through, not a depression, soft or otherwise.

Simon Says Sell Copper

But first, I want to briefly comment upon what will be for most of you an obscure drama happening in the copper trading pits of the world. I call it to your attention because it illustrates the growing importance, and potentially growing sophistication, of China to the world commodity markets.

My source for the following is a series of letters from Simon Hunt. There is no better authority on copper and China than Simon. He travels extensively each year in China going to producers and buyers to get a real feel for what the demand for metals will be. Now let’s go to the drama.

China is massively short of copper, on the order of hundreds of thousands of tons. The exact amount it still subject to rumor. Why would China, who needs more and more copper each month, be so short? The market thought it was the Chinese State Reserve
Bureau (SRB). However, the SRB announced a few weeks ago, amidst all the wild rumors, that it was a trader associated with them and not the SRB that was responsible for the shorts. Shades of Nick Leeson.

“When asked about the rumored shorts of the SRB in the market done by its previous senior trader, he replied, “The shorts done by him are his and not ours. We have no evidence about the shorts. The trader was on leave and would be back to work soon. When he has come back we may want him to clarify it.” (Simon Hunt)

“…Wild rumors have seen the front pages of the world’s press in recent days. In our view, the media stories for the most part are a mixture of mistruths and half-truths. The SRB is short of 100-200kt; the losses run into hundreds of millions of US dollars; the SRB has little copper and most of that is old, domestically produced material; they are bluffing, because they cannot even deliver 200kt; the senior trader of the “Centre” has gone missing; brokerage houses stand to lose millions; senior executives have either resigned or been fired. It is a tale fit for a James Bond movie not an event that embraces China and the LME [London Metal Exchange].” (Note to financial press: if you want to really know what is happening, call Hunt. Leave the rumor mongering to the tabloids.)

In the same release they also said they were going to deliver into the market 200,000 tons of copper. (As noted above, many market participants think they are bluffing.) The missing trader, Qibing Liu, did in fact turn up. It seems that he was trading for a group that is definitely associated with the SRB, if not directly the SRB, and perhaps for some well-placed Chinese individuals.

They are in fact massively short, but short over a three year period, through what appears to be some sophisticated spreads. The Chinese are well aware that traders are taking price benefit of their need for ever growing amounts of copper, and that Chinese demand is a big part of the rising copper price. Quite simply, they are being taken advantage of, and they don’t like it. Their manufacturers are taking truly massive losses because of the price rise. Many of these are state companies.

We should be sure of this. When the Chinese say they are going to deliver copper into the market, they are not bluffing. They cannot bluff on this and ever be taken credibly in the copper or any other market. If they say they are going to deliver 200,000 tons of copper, believe it.

It looks like China has some 1.5 million tons of copper in its reserve. With announced plans, it also appears that they can simply dip into those reserves until the middle of 2006 without putting stress on their true reserve need. If China does not import copper for six months, it is going to have a severe (in my opinion) impact upon the price of copper.

And now we depart from Simon’s wise words and go to Mauldin’s wild conjecture. Let’s say you are the Chinese powers that be, and are sitting around in a restaurant, bemoaning the fact you are getting screwed (that’s a technical financial term)
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by foreign traders on metal prices in general and copper in particular. Someone quips, “We should show them and not buy any copper for a few months and let the price drop.” And then the light bulb comes on, because with your massive reserves you could do just that. And not for just a few months. You could cause some pain in trading rooms all over the world.

And so you decide to do it. But now you know that the price of copper is going to take a big hit. So what do you do? You build up a massive short position over a long period of time (say a three year spread). You know you will take some hits early on, but you meet those margin calls (Simon says it is around $20 million and not the hundreds of millions being quoted in the press) with either physical metal or cash, which is essentially pocket change for the SRB.

Then you meet your own copper needs for the next six months with copper from your reserves. You can go longer if you need to. China is a huge factor in the copper market, and if they take no imports for six months, we will see copper back up into the market and start spilling onto the docks. Prices will drop and drop some more. You cover your shorts, making a very tidy sum for your beneficiaries, whoever they are. You teach the market a lesson to not jack with you, because you could come into any commodities market at any time and do the same (assuming you have built up reserves). Prices should be more moderate in the future, with less of a China demand premium. You replace your reserves with lower cost copper in the process, partially paid for by your profits from the shorting.

Of course, there is the possibility that Quibing Liu is a Chinese version of rogue trader Nick Leeson, who took down Barings with his yen trading. But somehow I doubt it. There is still a lot of mystery to this, but as things get sorted out, I think the Chinese are going to look smarter than those on the other side of the trade. And it will make those traders less willing to put in a long term Chinese demand premium if they know they can get caught with their long positions by a bureaucratic decision to use reserves at any time. Interesting times. And now, back to Our Brave New World.

Our Brave New World, Part Two

Charles and Louis-Vincent Gave, along with Anatole Kaletsky have written a brilliant and easily read 150 page book called Our Brave New World. You can read the first part of my review by going to the archives and reading the letter dated November 11 (click here). Dennis Gartman wrote yesterday in his daily commentary, after reading this book, that:

“Share are higher once again and we shall reiterate the comment made here yesterday that the markets are moving higher on the strength of the companies that our friends at GaveKal refer to as ‘platforms.’ Until proven wrong, the trend of tech-dominated NASDAQ is higher, while the trend of the GM’s, Ford’s, Alcoa’s, US Steel’s and the like are downward in broad terms. The ‘platform’ companies sell high margin design; the others sell low margin manufacturing. In the post-industrial age, we need to own the former and to be short of the latter.
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“We were asked yesterday, ‘Is this not a marked change from your often repeated trading dictum that you want to own the things that if dropped on your foot will hurt?’ Our answer is ‘Yes, unequivocally!’ Our notion first put forth several years ago, and repeated almost ad nauseum in the months and years thereafter, that we wanted to own ships, and steel, and railroads, and coal and ball bearings and the like served us very, very well. However, upon reading Gave, Gave & Kaletsky’s book Our Brave New World we have come to the simple understanding that, in the words of Lord Keynes, ‘The facts have changed, and when the facts change, we change.’ The ‘facts’ of the world have indeed changed, and we want to own design firms, software firms, pharmaceutical firms, firms that sell high end services, companies like IKEA (if it were public) that sell high end goods but have all of the manufacturing hived off to the cheapest place of manufacture and can drive costs down while holding margins high. The facts have changed and we need to understand that.”

Dennis is a very savvy trader. He does not lightly change his base philosophies. I was very surprised to read that statement. But this underscores my suggestion that this is an important book. You can get the book for $20 (shipped) at www.gavekal.com. It is an important book and I urge you to read it.

Summing up from last time, they argue that “platform companies” are the wave of the future. These are companies which design and market, but let someone else manufacture. Thus they have lower capital costs and are less subject to economic downturns, as they have no factories to shut down or workers to lay off. There are no legacy costs and no unions to fight.

Some moan the loss of those jobs, saying it will cost those countries dearly. But so far, those who say so are wrong. Yes, the US has lost million of manufacturing jobs, yet today we have more employment than at any time in history. And further more, we are on average making more than at any previous time, and paying more in taxes. We can moan about the pitifully small rise in real and nominal wages, but they are in fact rising and not falling.

There are those that argue that losing that manufacturing capacity is going to come back to haunt us. We are being “hollowed out,” as one observer (whose name slips me) remarked. GaveKal argues that those jobs are not economically important (except, of course, if it is your job). Other jobs will replace them. An analogy would be the farm jobs in the late 1800s, as machines, both labor saving and transportation meant more production at ever lower costs. It also meant the price of food dropped in a slow inexorable rate for almost four decades, as production of food did not have to be within a short distance from the markets.

Quoting from GaveKal’s newsletter written this morning, “But platform companies don’t have to sell a special product whose price is insulated from the broad economy. They can sell anything. In fact, if anything, given the nature of the global economy, there aren’t going to be many products insulated from the global pricing
structure - even services. So, platform companies are the new growth companies - not by virtue of what they sell, but by virtue of how they are organized.

“As more companies move to the platform model, we should witness less volatile and higher earnings growth in the US. And with low rates held down by the above conundrum, low rates foster, on balance, more supply than demand. Which means that those companies successfully executing on a platform company model should be accorded the highest multiples. In an inflationary boom (or the appearance of one the last few years), demand is even with, or greater than supply, so producers do well because they can get price. Today, producers reside mostly outside of the US. And sure enough, emerging markets and EAFE have outperformed the US is the past year. But this might now be turning around.

“In a deflationary boom supply is greater than demand so consumers typically do well. Platform companies are in the US (mostly) and, on balance, are more akin to consumers than producers - or maybe they are prosumers, as Toeffler wrote thirty years ago.

“Once the Fed absorbs the monetary overhang (and supply boom) it created in the 2001-2004 easing campaign, the unique situation of rising asset prices and commodity prices should resolve itself through lower commodity prices. We suspect the trend of rising asset prices (a deflationary boom feature) reasserts itself in a rising US stock market. The Fed needs to raise rates enough to impact demand, but not kill it; it needs to raise rates enough, and keep them there, to try to impact global capacity growth some. To some extent (i.e.: Chinese property prices), this is already happening. In turn, this should help force economies that rely too heavily on investment-export models to change their methods of management. But all this takes time, and in the interim, we will face several years of slower global growth, plentiful products, and low prices.”

We will explore in a few weeks whether the Fed can be so precise in its endeavor to correct the monetary overhang it created, albeit in an effort to keep the US economy from suffering a serious recession after the 2000 market crash. But I agree with GaveKal that we are getting ready to enter a period of slower growth. The Muddle Through Economy is going to return and take up residence in the latter part of this decade.

Monetary Policy Turned on Its Head

The next thing that GaveKal argues is that monetary policy no longer works like it used to. “In the wake of the Asian Crisis, lower rates are more stimulative to supply than demand while it used to be that lower rates were more stimulative to demand.”

This is a subtle argument but part of an overall theme that we are in a deflationary world. Bonner would agree, but where he sees a negative aspect of deflation, they see a deflationary boom. Readers of Gary Shilling would recognize this position. Shilling has maintained for years that we will enter a period of what he calls good deflation.
At its roots, a deflationary boom exists when supply is structurally ahead of demand. Prices drop, and in a classic world, when prices drop demand rises, thus stimulating even more supply.

This, they point out, makes it easy for central bankers, if you assume the job of central bankers is to keep inflation under control. They do not have to worry about the supply side of the inflation model. Inflation can be created by not enough supply to meet demand. But when there is always “more stuff” coming into the market, inflation does not result from supply side problems.

That means that central bankers need only worry about the demand side of the equation causing inflation. Thus, raising rates will lower demand, taking away the demand driven inflation. If they need to stimulate demand, as they wanted to in 2001-02, they simply lower rates. But here is the GaveKal twist:

“In terms of managing demand, the Fed may have overdone the demand stimulation in 2001-04, but an important lesson was learned: low rates not only stimulate consumption in the US, but capacity expansion abroad even more. For a while, we get a window where demand surges (i.e.: US housing cycle, energy) and people believe we have entered an inflationary boom. For a brief period, it appears that demand has caught up with supply. But, monetary demand stimulation at the core also creates supply stimulation at the periphery. And while this is going on, investment in capacity looks like demand.

[Read the above paragraph again. It is important to understanding their argument – JM]

“At some point however, the rise in commodity and house prices we have witnessed in recent years will likely be viewed more as a reflection of capacity growth around the world, not true demand.

“Because low rates are a reflection of the deflationary backdrop, not the cause, the Fed simply can not lean into demand too hard by raising rates aggressively; otherwise they risk a real deflationary bust. The Fed thus has to raise rates gingerly and talk tough - walk hard, but carry a small stick. And since prices don’t structurally take off, core inflation measures around the world stay tame.

“Whatever central bankers want to do, they cannot change the reality that supply is in excess of demand. So the complexion of activity is decent volume growth but muted prices. This likely means that the next time the Fed has to lower rates aggressively, the curve won’t be as steep as the last go around. In our old MV=PQ framework, when curves are steep, currencies fall, and deficits widen, companies can monetize higher prices. Income statements are inflation pass throughs. However, investors usually don’t like to pay a lot for that (which is why multiples have fallen over the last few years).

“Today, those forces are in reverse. Companies can not rely on the crutch of
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price; companies have to monetize volumes. This is much harder to do; and investors are willing to pay a premium (i.e.: Apple) for companies that can do it.”

By “rely on the crutch of price” GaveKal means that companies simply cannot raise prices to increase profits. They have to sell more “stuff” at lower prices to increase total profits.

This is a chicken and egg analogy, but an important distinction. Yes, the Fed did want to stimulate demand when they lowered rates. But they also made cheap money (with the help of other central banks, and especially Japan) available WORLDWIDE for increasing production. Thus, China has some 1,000 ball bearing companies when it needs maybe 10. Each day the managers of those 1,000 companies wake up trying to figure out how to get to be big enough to be one of the 10 who will survive. And that means growing even more capacity which is not really needed. They do this by borrowing money, getting foreign investment, offering lever lower prices, etc. And since rates are low and the money is easy to come by, they have every incentive to do so.

It is the same for chips and copper wire and appliances and, well, just about everything. And the developed world responds by letting the developing world (not just China!!!) do the low profit manufacturing and keeps the profitable design and marketing parts of the business. And this results in a trade deficit.

The Final Heresy and the End of the Welfare State

We shall see that Bonner, et al, do not like the dollar asset standard. Good old gold is what we need as a basis for money. Yet GaveKal not only asserts that a dollar asset standard is developing, but that it is superior to gold. Quite simply, they argue that since gold cannot grow at a fast enough pace to maintain global growth, it HAS to be replaced, otherwise we revert to a world where consumers lose and governments dominate by their power of controlling gold flows. Now, let’s turn to page 109 in our hymn book and let them explain how they see their Brave New World developing:

“If we assume that a new part of the world is getting richer (China, India, Russia, Brazil, etc.), then we should probably assume that some entrepreneurs in those countries are making it big. This assumption is not a stretch; there is enough anecdotal evidence to support it (if you doubt that some new entrepreneurs are making it big, go to the Louis Vuitton store in Shanghai on a weekend). If we further assume that, in the countries getting richer, we will start to witness the emergence of institutional savings (pension funds, mutual funds, family offices, etc.), then we should expect big ‘savings flows’ from the rapidly growing developing world into the Western world.

“In simple words, the emerging markets’ newly rich will feel like investing a part of their newly created wealth in regions of the world where property rights are well protected and where there is a rule of law. The excess trade balances earned by the ‘industrial world’ have, in fact, little choice but to be reinvested in the assets of the ‘creative world’. The pension funds of the ‘industrial world’ will buy the companies.
which give their countries work. The successful individuals in the ‘industrial world’ will also buy real estate in the ‘creative world’ (because it also happens to be the ‘fun world’).

“This implies that the assets in the ‘creative world,’ and especially the prestige assets will always border on the overvalued. Similarly, given the ability to change a producer if he becomes a little bit too demanding, asset prices in the industrial world will remain a little bit undervalued at all times... Which brings us to the following point: balance of payments consists of two parts:

1. **The Capital Balance:** if the above holds true, that part will always be positive for countries with well developed financial markets.

2. **The Current Account:** since the two parts add to zero (by construction) it means that the current account in countries with well developed financial markets (US, UK, HK etc.) should always be in deficit, and massively so...

Taking this a step further, we can assume that, as a result of the constant capital flows, the countries with a well developed capital market will have an overvalued currency and a very low level of long rates. Which in turn leads to robust real estate markets (see chapter 8) and higher asset prices.

“We call this ‘the dollar asset standard’. Basically, diversified and safe assets in the Western world replace gold as the standard of value in the eyes of new savers in Asia, Latin America or Eastern Europe.

“The first implication of this new ‘dollar asset standard’ is that overvalued currencies, combined with a low cost of money (i.e. low barriers to entry), will prevent anybody in the ‘developed financial market world’ from making any money in industrial goods. In turn, this development will ultimately force companies in the developed financial market world to move to the ‘platform company’ business model, specializing in design and in marketing, and letting someone else produce the goods.

“But this is where it gets interesting: once they make the switch to the ‘platform company’ model, a number of companies will likely realize that they should domicile their research and marketing activities in countries with low marginal tax rates, both for their shareholders and their employees.

“To some extent, this has already happened in the financial industry. On any given day, the biggest foreign net buyer or seller of US Treasuries is the Caribbean Islands. Now needless to say, the Caribbean islanders are not amongst the world’s largest investors; but the hedge funds domiciled there most definitely are. So the ‘efficiency capital’ of the world, which used to be domiciled in big investment banks in the world’s financial centers (whether London, New York, Frankfurt, Tokyo…) has now re-domiciled itself in hedge funds whose legal structures are in the Caymans, Bermuda, the British Virgin Islands etc. The tax revenue on the ‘efficiency capital’ is now lost for the US, the UK and others…and there is little they can do to gain it back.
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“And it’s not just in finance that this is happening. Hong Kong Land, a property developer is incorporated in Bermuda. Electronic Arts, one of the world’s biggest video game designers is incorporated in the Caymans…. As an increasing number of companies move to the ‘platform-company’ model, it is likely that the top talent will want to work, or at least be taxed, in low tax environments. This will lead to a collapse in tax receipts in countries that do not adjust to this new model. In the new world towards which we are rapidly moving, income taxes will becoming increasingly voluntary and governments will have to get their pound of flesh through property and consumption taxes instead. This should lead to more efficient (i.e. downsized) governments all over the Western World. The platform companies might end up killing off the Welfare State.”

This sounds like James Dale Davidson and Lord Rees-Mogg in their important book written a few years back called The Sovereign Individual, although GaveKal comes to the same end from a different road.

And it is an idea to which I subscribe, though for different reasons. It will not just be the pressure from platform companies wanting to avoid taxes that will precipitate that change. I would make the argument that the current generation (in nearly every country in the developed world) and our forebears have written a check in the names of our children which they will not be able to pay. By this I mean our social security and pension programs. And if they cannot pay it, they won’t. The social contract between generations and governments is going to be re-written in the next 20 years.

We live in interesting times.


Home, New Books and the Good Life

After a whirlwind travel schedule for the last two months, I find it very easy to contemplate no travel for almost two months! I am really looking forward to catching up on a lot of things left undone, both business and personal. And getting into the gym on a regular schedule will be a real pleasure. There are bets among my family whether or not I can really go until the middle of January without getting on an airplane. Something will happen, they say. Well, maybe. I will admit to not being confident enough to take that bet. But one can hope.

And speaking of books, my editor at Wiley (Debra Englander) tells me my new book, Just One Thing, is doing well. Re-orders are coming in nicely. I am quite pleased with the reviews (well, almost – there is one that is annoying, but then he didn’t read the book, so that probably does not count as a review. Just has a personal need to trash authors, I guess) and sales, and suggest you get a copy. It will make a great Christmas gift. To find out more about the book, you can go to (Doug, insert link to my promo page for Just One Thing) or you can buy it at www.amazon.com/justonething.
Thanksgiving was a great deal of fun. With all seven kids, and my mother, brother and sister and nieces and nephews, plus boyfriends and assorted others showing up, we had a houseful, as well as way too much food, which we heroically tried to consume. It will take more than a few sessions in the gym to work off the aftermath of yesterday’s binge.

It was the Good Life. Life at its best, except maybe for the Cowboys choking a game to the Broncos. All the travel, work, writing and so on, and the great pleasures are still the old ones. Family, friends and those special times. I am finishing up early this Friday so I can get back to the kids while they are still here. I think Harry Potter is the order of the afternoon. It is time to hit the send button. I wish you a great week.

Your really glad he is not at a mall today analyst,

John Mauldin