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Obama's Economic Inheritance

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Obama's Economic Inheritance

The global economy has a new leader. Barack Obama won the US Presidency because of the financial and economic collapse of 2008. The world now looks to him to restore confidence in an economic system which is under unprecedented strain. His election represents a good moment to survey the state of the world economy, and the risks it faces in the period ahead. In particular, this paper will ask whether the risk of depression and deflation is real, and whether the US authorities have the wherewithal to head it off.

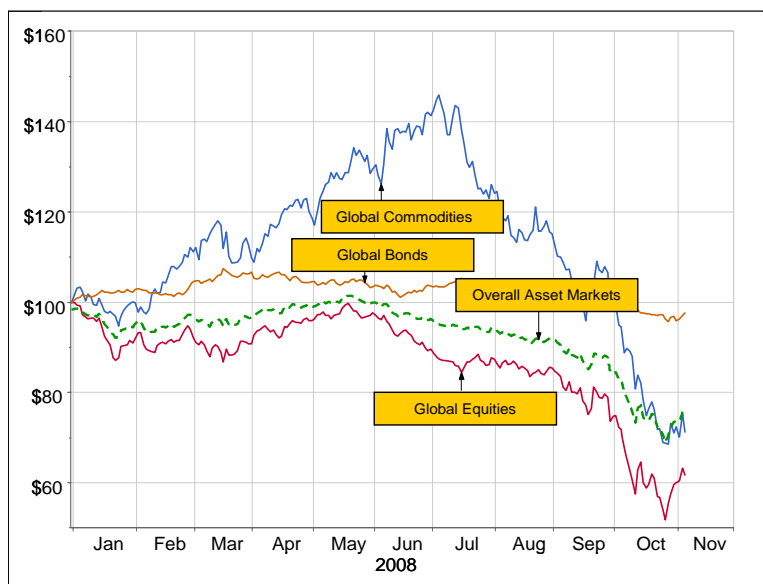
In the month just ended, US equities fell by 19%, more than in any month since 1932, when the American economy was midway through a recession which would see the level of real GDP drop by 27%. Equity volatility (and therefore the implied cost of insuring against further declines in share prices) touched the highest levels since 1933. Investment grade bond yields in the US, compared to the yield on "safe" government bonds, were also higher than they have ever been since the Great Depression of the early 1930s.

Is the world economy inherited by President-elect Obama really in such bad shape? The problems we face today are assuredly serious, and economic activity data for October have been truly dire. The global banking system, if left without government support, would have gone entirely to the wall this autumn. Although the immediate risk of bankruptcy for large financial institutions has been virtually eliminated by unprecedented government action, and the interbank markets are beginning to function more normally, the economic effects of the financial melt-down are only now beginning to be felt. A worsening credit crunch is throttling the supply of loans to banks' customers in the household and corporate sectors. It is all but a certainty that all the major developed economies will experience a sharp nosedive into recession in the current half year, and only a few optimists now believe that the emerging countries can avoid a similar fate. A truly global recession, probably the worst since at least the 1980-82 episode, is now "nailed on", as they say.

The financial markets have understandably reacted sharply to these dramatic events. At the end of October, global equities had dropped by 38% year to date, and had experienced their worst 12 month decline since 1938, when Hitler's tanks were rumbling through central Europe. Normally, a large decline in equities is cushioned in diversified portfolios by increases in other asset classes, but not this year. At end October, commodities were down by 29%, and even global bond returns were slightly negative at -4%. Hedge funds, on average, have lost 19% this year. In the financial markets, there really has been nowhere to hide (Graph 1).

Graph 1 →

Performance of Major Asset Classes in USD





However, there have recently been some chinks of light. The decline in commodity prices will have a very large stimulatory effect on the global economy which should not be downplayed, and markets have stepped back from the edge of the precipice. In the last week of October, US share prices rose by 10%, the largest weekly gain since 1974, illustrating how dangerous it can be to be underweight equities after a drop as large as the one recently experienced. There were further rises in risk assets just prior to US election day. It is far too early to say that the bottom is now in place: after all, the largest increases in asset prices almost always follow fairly hard on the heels of the largest falls – that is the nature of extreme market volatility. But a familiar market proverb, originally due to Baron Rothschild at the height of the Paris Commune in 1871, advises us to “buy when there is blood on the streets”. (More chillingly, Rothschild added “even when the blood is your own”, but most of us prefer to forget that.) He was right. Asset prices in 1871 had dropped to about half of their long term value precisely because there was fighting in Paris, and as soon as the violence ended, share prices quickly doubled.

The issue for investors is therefore whether the markets in October had fully discounted the full extent of the bad news which is still in store. In other words, was there *enough* blood on the streets? I make no pretence of knowing the answer with any certainty, but the outcome is likely to depend on the severity of the downturn in global economic activity, the impact of falling commodity prices (which will restore global aggregate demand) and the success or failure of policymakers’ attempts to battle deflation, and therefore prevent a recession turning into depression.

President-elect Obama will enter office with a clearly enunciated economic plan. It is very easy to see him dressed in the clothes of Franklin D. Roosevelt. FDR was and is a controversial figure in American politics, but there is no denying the fact that, under his leadership, real GDP rose by 58% from 1932-40 (Graph 2). This recovery was unthinkable when FDR declared that “the only thing we have to fear is fear itself” in his inauguration speech in March 1933. Many of FDR’s ideas were unique to their times, and look anachronistic today, but two of his hallmarks have clear echoes in the Obama rhetoric: “fairness” and “economic stimulus”. The markets will not like the redistribution elements in Obama’s tax proposals, and will worry about their long term impact on the return on capital and the underlying growth of GDP. But the dominant element of the plan in the short term is that it will involve a Keynesian fiscal stimulus of more than \$300 billion in the first half of next year, and quite possibly an increased willingness to “encourage” the banks to support the economy by increasing their loans to households and corporations. Since markets have until very recently been fretting about the risk of depression and deflation, the increased probability of extra help for domestic demand should be seen as a strong positive.

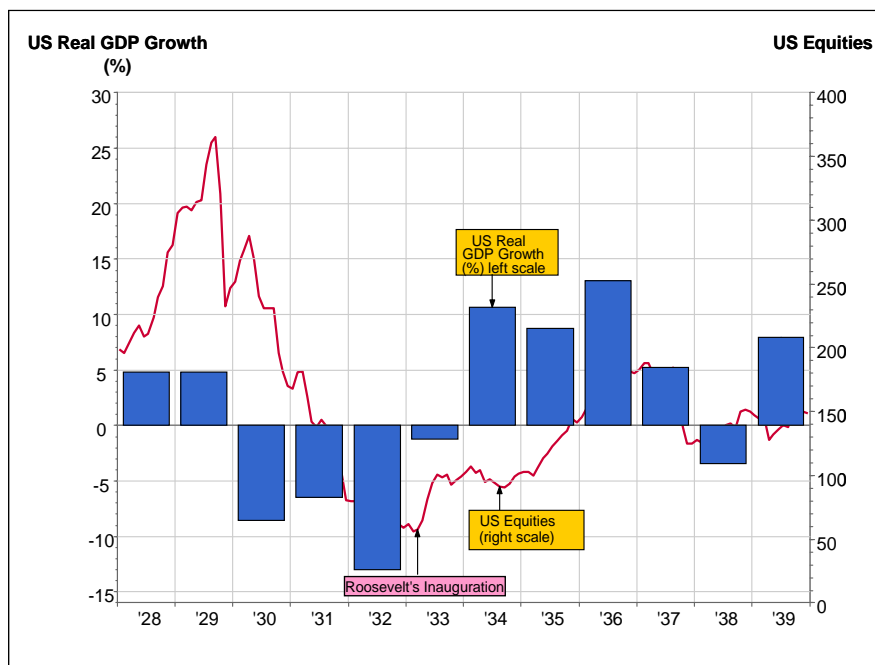
Furthermore, the markets have not yet understood the full importance of Ben Bernanke’s plan to combat deflation risk. This plan was spelled out by Mr. Bernanke in a seminal speech in 2002. As we will see later, he has been following the game plan outlined then in uncanny detail. If the worst happens, and the economy heads towards depression or deflation, there are several more steps which will be taken under the Bernanke blueprint, including the monetization (or printing of money) to cover any further increases in the budget deficit. Mr. Bernanke is likely to see eye to eye with the Obama economics team on the appropriateness of these further stimulatory measures, even if they will appear dangerously unorthodox to many branches of the economics profession. Dangerous times might require unorthodox remedies, and America now has in place a team which might be suited to the occasion. If this reduces the chances of depression, then markets should welcome that development, even though it may take more market disruption in the immediate future to persuade the new administration to act with the required vigor.



Graph 2 →

Could It Happen Again?

The US Economy and Stock Market in the 1930s



The Global Downtown

The peak of the recent upswing in global economic activity occurred in 2007 Q2, following four successive years in which global GDP expanded at more than 5% per annum, the best period of growth since the early 1970s. As on that previous occasion, this prolonged expansion triggered a surge in commodity prices, which reduced the growth of disposable income in the developed world sharply. (The impact of higher oil and food prices on the annual rate of growth in personal disposable income was -2.7% in the US, and -1.7% in Europe by 2008 Q3.) Initially, this caused a gradual slowdown in consumers' expenditure growth in the developed economies, which was exacerbated in the US by an implosion in the housing market, and in homebuilding. In consequence, the slowdown in GDP growth in the second half of 2007 was more marked in the US than in Europe or Japan, while there was no slowdown at all in many emerging economies which benefited from higher commodity prices.

What had at first been a gradual consumer slow-down focused mainly in one country (the US) showed signs of worsening and broadening out by the middle of 2008, for several reasons. First, the European economies started to feel the impact of a rising Euro and tight ECB monetary policy, and they had stopped growing by 2008 Q2. Second, some emerging economies began to see slower export growth to their main markets in the US and Japan, while others were quickly impacted by the bursting of the commodity price explosion in July 2008. Third, there was probably some adverse impact by 2008 Q3 from the confidence effects of lower equity prices, and from the credit crunch. Consequently, it seems that real GDP has been in negative territory in Q3 in the US, Europe and Japan, though not necessarily by anything worse than -1% at an annual rate for the G7 as a whole.

We can therefore say with some certainty that the developed economies had entered a mild recession by 2008 Q3. In fact, when the economic historians have done their work, it is likely that they will date the start of the recession in 2007 Q4 in the US, and 2008 Q2 in both Europe and Japan. Until mid-September, however, few economists believed that the downswing would take on the sinister proportions that are now threatened. Admittedly, the

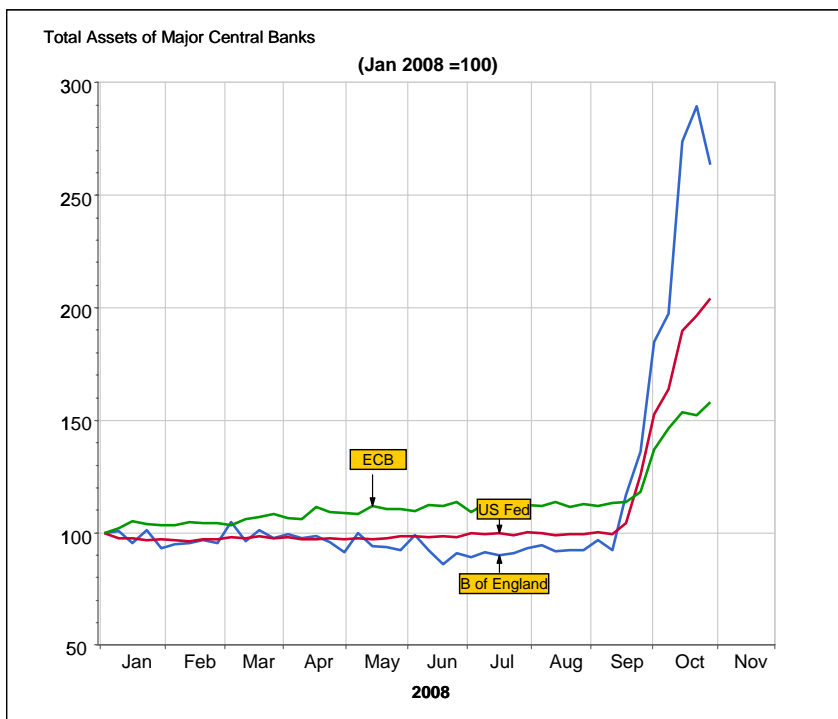


banks were severely struggling under the impact of large scale write-downs of mortgage and other credit related assets, but a systemic collapse in the financial system was apparently being held at bay by injections of liquidity from the central banks, in exchange for a widening array of collateral. This changed abruptly when US Treasury Secretary Paulson allowed Lehman Brothers to fail on 15 September, taking down not only the stock and bondholders of the company, but also its asset market counter-parties and prime brokerage customers, many of whom became general creditors of the failed entity. Mr. Paulson subsequently said that at no time did he consider that it may be appropriate to use public money to rescue Lehman or its counter-parties and customers. If not, then perhaps he should have done, because the total collapse of Lehman led directly to “the greatest financial crisis in human history” (according to the Deputy Governor of the Bank of England). As confidence drained from the system, financing lines were abruptly withdrawn from banks, investment banks and hedge funds, many of which were in immediate danger of outright failure. The unthinkable appeared to be on the horizon – a repeat of the early 1930s when more than half of all bank deposits went under.

Once they had been forced to stare deeply into the abyss, governments and central banks combined quite quickly to implement a series of measures which had previously been deemed out of the question. In the US and most of the major European countries, four crucial steps were taken, though not in equal measure in each country. First, public money has been used to inject capital into the financial system, resulting in the partial or full nationalization of many iconic private sector institutions. This is intended to provide enough capital for these entities to continue their lending operations without breaching capital adequacy ratios. Second, more public money has been set aside to purchase the impaired assets of financial institutions. Third, accounting and regulatory changes have been introduced to enable financial companies to write down their failed assets over longer time periods, thus disguising the full extent of the mark-to-market losses. And fourth, the central banks have greatly increased their liquidity provisions to the system. The Federal Reserve, for example, took 95 years to build up a balance sheet of \$850 billion, most of which consisted of US government bonds. It has more than doubled this balance sheet in a matter of weeks (Graph 3), accepting “assets” of very questionable status in exchange for burgeoning loans to private bodies.

Graph 3 →

Liquidity Injections by the Major Central Banks

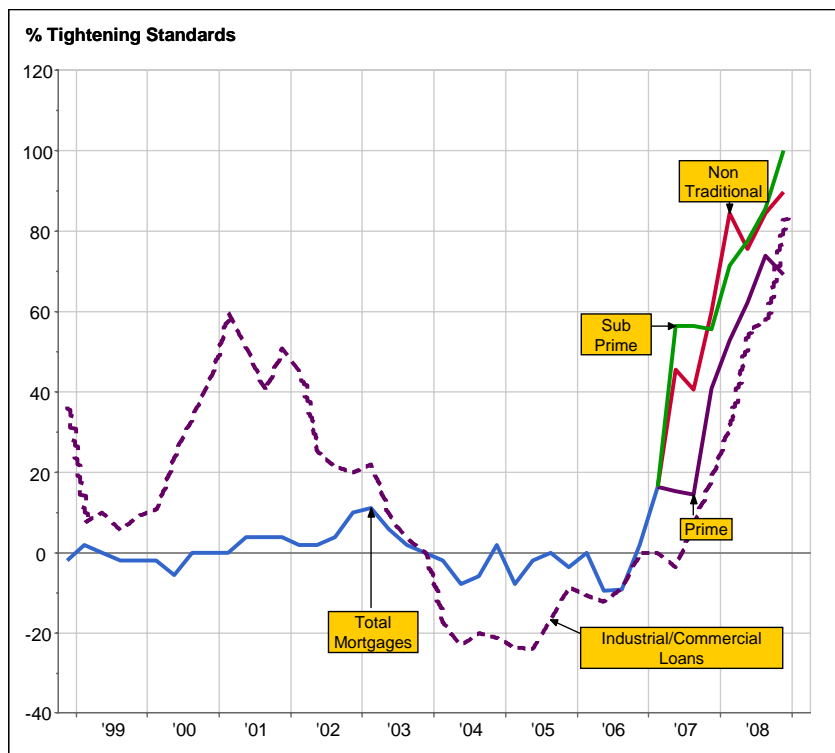




It is becoming increasingly clear that these unprecedented events have dealt a very severe blow to confidence in the household and corporate sectors across the world. In addition, it appears that the provision of working capital has dropped dramatically as banks have hoarded liquidity for themselves, and have tried desperately to cut down the availability of liquidity for their customers (Graph 4). Even profitable and healthy companies can quickly be brought down by restrictions on the availability of working capital. The consequence of this cold fact has been a sudden, very large retrenchment by the corporate sector, which has curtailed any form of spending which could be rapidly reduced.

Graph 4 →

**The Credit Crunch - US
Loan Officers --
% Tightening Standards**



Inventories have been slashed, capital expenditure has been put on ice, and recruitment has been halted. Furthermore, the unavailability of trade finance has severely impacted the flow of shipping and air freight, as well as trading in oil and other basic commodities. The Baltic Dry Index, a measure of shipping costs, has fallen by about 90% since last June. It would not surprise me if the current quarter saw the most abrupt slowdown in world trade volume in the post-war period.

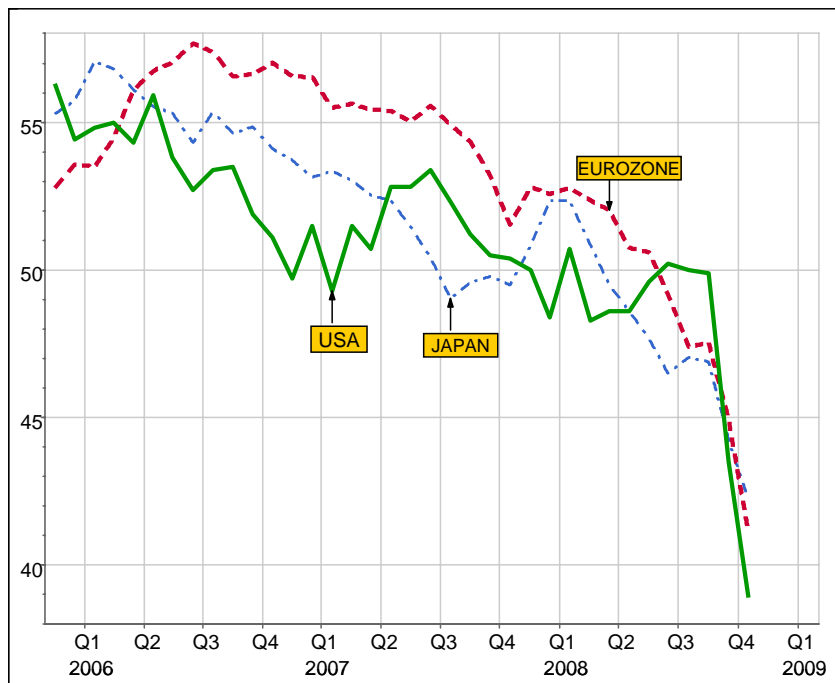
The developing recession has therefore changed gear on two occasions in the past few months. What had originally been a gradual consumer and housing retrenchment focused mainly in the US widened markedly to involve many more countries in 2008 Q2, and then nosedived dramatically at the end of Q3 as corporate spending was slashed indiscriminately. It is not yet possible to judge the depth of the global recession which will be recorded in 2008 Q4 and 2009 Q1, but it is likely to be very deep by post-war standards. At present, the key business survey data in the US, Japan and Germany are all pointing to a downturn which will be as deep on entry as the two previous worst post-war recessions in 1975 and



1982 (Graph 5). It is perhaps understandable that sentiment indicators have collapsed, in view of recent news flow, but the harder economic indicators in the surveys – orders, inventories, employment and exports – have all declined ominously. Mainstream macro-economic forecasters (who admittedly have not done very well in predicting the events of 2008) are now looking for quarterly annualized growth rates in Q4 of -4% in the US, UK and Japan, and -2% in continental Europe. While the current quarter is generally seen as likely to record the worst growth rates in the recession, almost all forecasters now predict another sharply negative outcome in 2009 Q1, and many predict further negatives in Q2.

Graph 5 →

Global PMI Surveys (Manufacturing)



Furthermore, it now seems highly improbable that the major emerging economies can escape the brunt of this recession. A few months ago, it seemed plausible to argue that the domestic conditions in the BRIC economies would be strong enough for them to avoid recession, and maybe even to contribute to an early recovery in the developed world. But this degree of “decoupling” now appears to be improbable. The scramble for liquidity in the past few weeks has seen financial crises developing in many parts of the emerging world, notably in countries which have large holdings of dollar-denominated foreign debt. This debt has become much harder to roll over, forcing emerging countries to purchase dollars to pay down debt ratios. This has become increasingly difficult in an environment of a rising dollar and falling commodity prices, so we have seen traditional emerging currency crises in many countries which were previously deemed safe from contagion. As in previous financial crises, panic has spread to all countries, whether or not they are particularly exposed to high foreign debt ratios. Consequently, countries like China, South Africa, Singapore and Malaysia, where fundamentals relating to debt and leverage are strong, have tended to suffer just as much as countries like Hungary, Poland, Brazil, Korea and Turkey, where fundamentals are much weaker. (Incidentally, Brazil and Russia are roughly in the middle of this league table, in terms of fundamental vulnerability to liquidity shocks.) Furthermore, at end October, emerging market equities had lost most of the gains they had

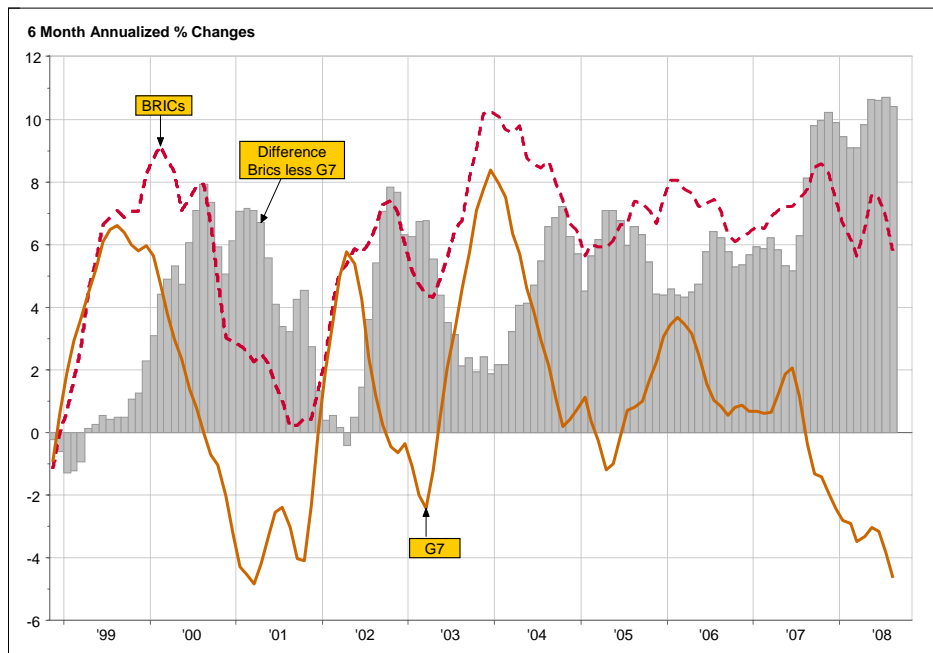


made in the previous two years against developed markets. Since the peak in relative performance in June 2008, emerging equities have dropped by 31% even against tumbling western markets.

Although leading indicators in the major emerging economies have not yet collapsed as they have in the developed world (Graph 6), widespread recessions are nevertheless probable. Because these countries have such high underlying GDP growth rates, they are most unlikely as a group to record negative GDP growth. However, a drop in growth to about 3% for the entire block would be less than half the growth rate recorded in 2007, and would clearly qualify for the description “recession”.

Graph 6 →

OECD Leading Indicators



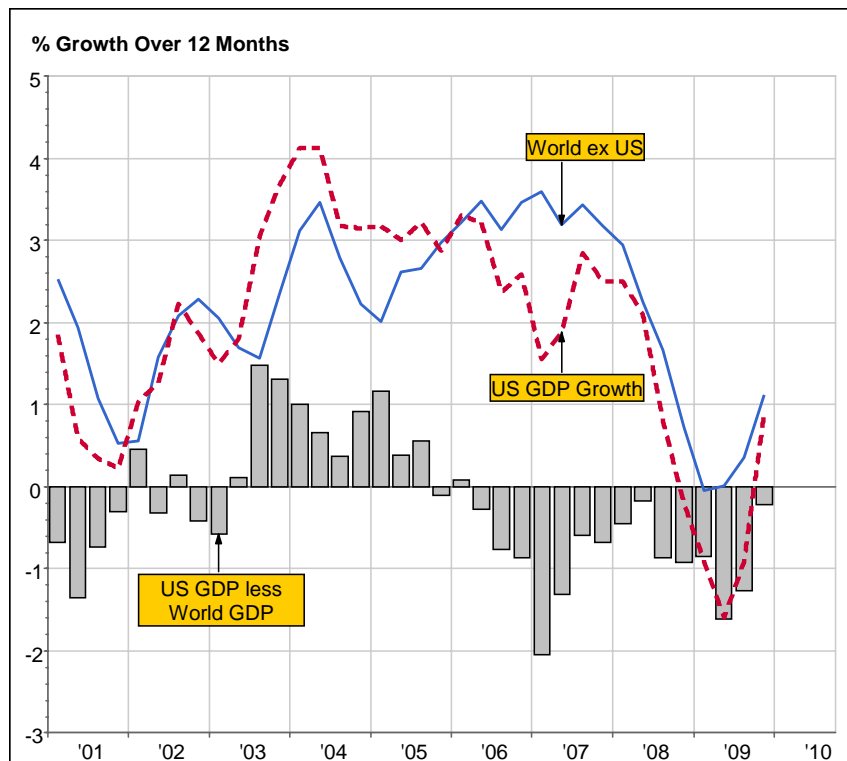
The fact that the present global recession is likely to be deep in its initial phases does not necessarily make it certain that the recession will be very prolonged. It seems probable that the long-awaited normalization of US and UK household finances is now underway, after about two decades in which personal savings ratios were unsustainably low. The loss of wealth suffered by US households this year will exceed \$1.5 trillion, which is more than one whole year's GDP. (Not the growth of GDP, the level of GDP.) Rising savings ratios will probably be needed to replenish this lost wealth, and this will be a drag on the system for quite a while. (Graph 7)



Graph 7 →

**US GDP Growth
Relative to the Rest
of the World (% over
12 months)**

**Mainstream Macro
Forecasts for
2008/09**



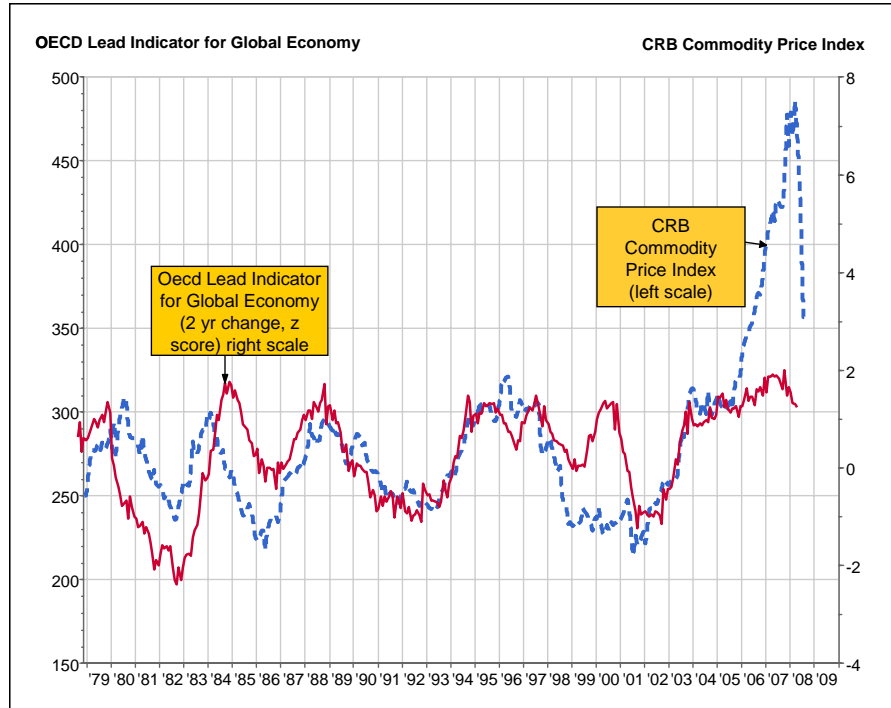
Everything now depends on whether demand growth can quickly be restored to adequate levels during a period of long-term consumer adjustment, combined with shorter term corporate retrenchment. One factor – the sharp drop in commodity prices – seems to be pointing unequivocally in a positive direction. Another factor – the capability of policymakers to stem deflationary forces if they emerge – is perhaps more important, but much less certain. Let us consider these two forces in turn.

**The Reversal in
Commodity
Prices**

Only three months ago, though it seems like an aeon, economists and the markets were thoroughly afraid of the possibility of stagflation, stemming from rising oil and other commodity prices. This prospect was truly worrying, since central banks have no weapons which can combat the adverse shift in the supply curve in the economy triggered by rising commodity prices. This simultaneously causes recession and inflation, as it did in 1974/75 and 1980/82. Fortunately, however, this prospect no longer seems to be on the immediate horizon, because of the collapse in commodity prices which started in July. Oil prices have more than halved since then, and other commodity prices have dropped by an even larger amount since their peaks earlier in the year. It now appears that much of the earlier ramp up in commodity prices was caused by speculative activity, which pushed prices far higher than could be justified by the long-term marginal production costs in energy, food and basic material markets. In addition, the drop in global GDP growth has coincided with the delayed effects of higher prices on commodity demand, producing a sudden easing of immediate market pressures. Although a renewed rise in commodity prices seems probable in the medium term, this could be some years off, given the problematic supply/demand fundamentals for most basic products. (Graph 8)



**Graph 8 →
Global Commodity
Prices and World
Economic Activity:
Commodity Prices
Still Coming Down
to Earth?**



Much of the damaging effect of the earlier rises in commodity prices will not just disappear, but will move entirely in the opposite direction. For example, in the US, the rise in food and energy prices has added 2.7% to consumer price inflation in the last 12 months, and subtracted a similar amount from GDP growth. This will now flip entirely in the other direction, reducing CPI inflation and adding to GDP growth by 2.7% over the next 12 months. (The equivalent figure in the EU is 1.7%.) The beneficial effects of these changes, which are only just becoming apparent to consumers in the major economies, will be large and timely, and will be equivalent to a very major reduction in household and corporate taxation, arriving at precisely the moment when it is most needed. This major bonus for economies and markets has been almost entirely overlooked in the recent gloom, allowing scope for favorable surprises when the inevitable benefits show through in coming months.

**Deflation and
Policy
Response**

Ironically, however, the drop in commodity prices will make another problem worse, and that is the threat of deflation in the western economies. This is what the markets really appear to be worrying about, since it is the factor which could turn the present recession into something much more serious. Deflation is defined as a pervasive decline in the general price level, not just a decline in the relative prices of a few goods, which is an inevitable feature of a healthy competitive economy. When the general price level starts to decline, three very dangerous things can happen. First, real (inflation adjusted) interest rates rise, and the central bank may be powerless to prevent this, because they cannot reduce the level of nominal interest rates below zero. As the rate of deflation gets larger, the real rate of interest actually increases, and this perversely tightens the stance of monetary policy. Second, the real level of debt in the economy also rises. Most debt is denominated in fixed nominal quantities (\$100 for instance), so when the price of goods declines, more goods are needed to pay down the same quantity of debt. This process of debt deflation (identified first by Irving Fisher in 1933) inevitably increases bankruptcy risk. Third, consumers begin



to expect price declines to continue, and they may therefore delay purchases because the real value of cash is expected to be higher in the future than it is today. This reduces demand, pushing the economy further into depression.

Although 19th Century economies experienced fairly frequent bouts of deflation, this has become extremely rare in recent decades. It did however happen in the Great Depression in the US and elsewhere (1929-33 and again in 1937-38), and in Japan (1998-2007). In the former case, US price deflation reached a low point of about -10% in 1933, and returned to about -4% in 1937. In the second case, Japanese deflation never fell below about -1%, but it got stuck in slightly negative territory for almost a decade. Since both episodes had such unpleasant consequences for the real economy, and seemed intractable for policymakers at the time, the spectre of deflation understandably casts a chill on financial markets, and that is probably what is hanging over market sentiment today. We therefore need to ask how likely it is that the major economies will experience deflation, and then turn to the question of what policymakers would need to do if it did happen. Could they fix it?

The prospect of it happening is all too real. A recent IMF study of major banking crises suggests that the impact of such crises on real GDP is both deep and prolonged. In the six developed market crises most similar to today's, the average peak-to-trough decline in real GDP is 5.4%, a savage contraction by any post-war standards (Table 1). This would be quite likely to cause a period of outright declines in headline consumer prices, especially now that the drop in commodity prices is pushing in the same direction. On mainstream forecasts for real GDP, which do not involve output losses as large as those just mentioned, headline inflation will drop to about zero in the US in the second half of 2009, and core inflation (excluding food and energy) will drop to below 1%. It is but a short step from there to generate a period of negative headline inflation.

Fortunately, however, a prolonged period of negative core inflation would be another matter. According to recent work by JP Morgan, the US unemployment rate would probably need to rise to over 9% for a couple of years (from 6.1% now) before standard models would predict deflation in core prices. Although this might be towards the extreme end of the likely outcome in 2009-2010, it is far from out of the question. One of the unpleasant consequences of the success which central banks have had with holding inflation down to targets of around 2% is that there is relatively little margin of safety before deflation might be experienced.

A key signal of when the deflation threat is becoming a problem is the moment when the central bank cannot reduce real interest rates to the levels suggested by existing economic circumstances because the nominal interest rate is bounded from below at zero. This has not happened yet. A common technique is to use the Taylor Rule to translate particular output and inflation levels into the "desired" level of short term interest rates. According to Jan Hatzius at Goldman Sachs, the Taylor Rule currently suggests that the Fed funds rate should be around 1%, which is exactly where the actual rate currently sits. However, based on the further deterioration forecast for the economy next year, the Taylor Rule implies that the nominal funds rate should be -2% by mid 2009. Obviously, since this cannot happen, it indicates that real interest rates will soon be stuck at levels which are too high, adding to downward pressure on economic activity instead of working in the other direction.

So what could policymakers do about this if it occurred? The Great Depression was the worst episode in economic management in living memory, and that has also made it by far the most examined episode. When I first studied economics in the early 1970s, I was taught that the crowning jewel of the discipline was that we now understood how to avoid a repeat of the 1930s. John Maynard Keynes and Milton Friedman were the two master scholars of



the depression and their conclusions had much greater complementarity than usually allowed in popular discourse, which likes to portray them as polar opposites. In fact, as John Makin of the AEI has recently reminded us, both of them saw a surge in the demand for money as a key component of the collapse into depression in the early 1930s. For Keynes, this increase in the demand for money was the accompaniment to the drop in investment demand, which caused the massive fall in aggregate demand. The latter needed to be attacked by fiscal expansion which was not forthcoming until too late. For Friedman, the rise in the demand for money had the perverse effect of raising real interest rates at the wrong moment, and this force should have been (but was not) offset by an increase in money supply. The fact that the Federal Reserve failed to ensure that the money supply increased in line with the demand for money was, for Friedman, the cause of the depression.

Table 1: Costs of Previous Banking Crises

	Fiscal Cost (% of GDP)	Output Loss (Peak to trough decline in GDP, %)	Low Point for Annual GDP Growth (%)
Finland	12.8	-13.6	-6.2
Sweden	3.6	-5.8	-1.2
Norway	2.7	-3.9	2.8
UK	n.a	-2.6	n.a
US	3.7	-1.3	-0.2
Japan	24.0	-5.1	-2.0
Average	9.4	-5.4	-1.4

Note: All of the above crises took place during the early 1990s, except Japan (1997 onwards)

Source: IMF

The modern scholar who has best understood the Great Depression is, by a piece of extraordinary good fortune, the man who is in the best position today to prevent the recurrence of such a disaster – Ben Bernanke. Instead of having to wait while the Chairman of the Federal Reserve struggles to understand academic economic thinking on the crisis, we are in the happy position of being able to learn more from the writings of Bernanke himself than from anyone else alive today. Bernanke has written a crystal clear blueprint of how policymakers should handle a threat of deflation, and what is more he is following that blueprint, play by play, in real life. The best source on Bernanke’s thinking is his speech entitled “Deflation: Making Sure It’ Doesn’t Happen Here”, delivered when he was first on the FOMC in November 2002. (The text is available on the Fed’s website.) This speech has plagued the Fed Chairman ever since, because in it he referred approvingly to Friedman’s famous remark about dropping money into the economy from helicopters, but in it you will find a comprehensive list of actions which policymakers can take to head off a depression.

When there is a risk that the economy is headed towards deflation, Bernanke says that the first responsibility of the Fed is “to ensure financial stability in the economy”. He adds that “at times of extreme threat, the Federal Reserve stands ready to use the discount window and other tools to protect the financial system”. Next, he says, “when inflation is already low and the fundamentals of the economy suddenly deteriorate, the central bank should act more pre-emptively and more aggressively than usual in cutting rates”. But he admits that



this might not be enough, and suggests that it might be the case that deflation could take hold despite the fact that the Fed has already reduced the Fed funds rate to zero. What then, he asks? Crucially, he rejects the notion that the Fed is powerless once the funds rate has dropped to zero, saying that “under a paper money system, the central bank should always be able to generate increased nominal spending and inflation, even when the short term nominal interest rate is at zero”. The method by which this can be accomplished is simple. “The US government has a technology called a printing press that allows it to produce as many US dollars as it wishes at essentially no cost. By increasing the number of US dollars in circulation...the US government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that under a paper money system, a determined government can always generate higher spending and hence positive inflation.”

This is a remarkable statement from the Chairman of the Federal Reserve: he believes that deflation is *impossible* provided that the Fed follows the correct remedies. No equivocation.

Furthermore, he goes on to spell out the precise method which should be used to apply the remedy. Money should be injected into the economy through asset purchases by the Fed, possibly bolstered by expanding the menu of assets which it buys. He suggests that the Fed could pre-commit to holding the Fed funds rate at zero for a long period, but states that his personal preference would be “for the Fed to begin announcing explicit ceilings for yields on longer-maturity Treasury debt, say bonds maturing in the next two years.” This commitment would be enforced by the Fed offering to purchase unlimited quantities of two-year bonds at prices consistent with the targeted yields. If this were not enough, the Fed could extend the maturity of the interest rate ceiling to 3-6 year bonds. It could also “offer fixed term loans to banks at low or zero interest, with a wide range of private assets (including, among others, corporate bonds, commercial paper, bank loans and mortgages) deemed eligible as collateral”.

There is more. If the measures listed already prove insufficient, “the effectiveness of anti-deflation policy could be significantly enhanced by co-operation between the monetary and fiscal authorities....A broad based tax cut, for example, accommodated by a program of open market purchases to alleviate any tendency for interest rates to increase, would almost certainly be an effective stimulus to consumption and hence to prices.” Alternatively, or in addition, “if the Treasury issued debt to purchase private assets and the Fed then purchased an equal amount of Treasury debt with newly created money, the whole operation would be the economic equivalent of direct open-market operations in private assets.”

I have focused in detail on this speech because it seems to me to be one of the most prescient ever made by a central banker. Not only has much of the content already been implemented with uncanny precision in the past few months, the rest stands ready to be implemented if the Fed becomes convinced that the funds rate at close to zero is still too high to prevent deflation. Since this is clearly a possibility, based on mainstream economic forecasts (and still more so on anything worse), this carries a clear prediction on what would happen if the deflationary threat gets worse. The Fed would give clear guidance that it will hold the funds rate at close to zero for a long period ahead. It would then implement a ceiling on two-year bond yields, presumably not too far above a zero rate. It would enforce this via unlimited purchases of short dated government debt, extending this to longer maturities if necessary. And it would seek to co-operate with the Treasury to introduce further tax cuts, and asset purchases, financed by printing money, not by issuing government bonds into the market. Such an extraordinary program has never been seen in modern times (or indeed ancient times, as far as I know). But it could become a reality next year.



Would It Work?

The Bernanke plan to combat the threat of deflation would be controversial in some quarters. Indeed, it already is. As in the 1930s, and as in Japan in the 1990s, there are voices which object to such active use of the public sector and central bank balance sheets to “rescue” the private sector from the consequences of its own mistakes. Some argue that this involves injecting long-term inflation risk back into the system, while others argue that asset market bubbles could be reignited. Still others point out (rightly) that heavy government involvement in regulation and bank ownership has, at best, a chequered history. These debates will have profound political consequences, and the outcome is not likely to be the same in all countries. In the Eurozone, for example, there is a great deal of philosophical opposition to many aspects of the Bernanke blueprint, and in any case the monetization of budget deficits by the ECB is prohibited by treaty. Whether this makes the Eurozone more vulnerable to a deflation shock, because it ties the hands of the central bank, preventing policy responses which would be deemed desirable in a unified nation state, is open to debate.

Two consequences of the coming war against deflation are likely to cause considerable debate among economists, and possibly some consternation for markets. The first is the scale of the necessary increase in central bank balance sheets. This will automatically increase the growth of the monetary base (M0), and it could increase the growth rate of the broader monetary aggregates if the banking sector passes on the increased liquidity in the form of loans to its customers. The question is whether this increase in monetary growth will raise the rate of inflation in the short- or medium-term. In the short-term, it seems unlikely that this will happen; after all, it is impossible to have inflation and deflation, both at the same time. For now, the threat of deflation is being triggered by a surge in the demand for money and, as Friedman explained, an increase in the supply of money is needed in order to prevent a perverse increase in real interest rates. If the central banks allow the increase in the monetary base to remain in the system after the demand for money declines, and inflation pressures begin to rise, that would be another matter.

The second consequence of recent and forthcoming policy changes is that there will be a very marked increase in the level of budget deficits and public sector debt ratios. Budget deficits in the major economies have been running at around 3-4% of GDP in 2008, except in Germany where the deficit is close to zero (Table 2). The impact of the banking crisis will increase these deficits dramatically. It is easy to envisage the recession increasing the G7 budget deficit by 3% of GDP over two years, and any discretionary measures to ease fiscal policy could add another 1-2% to that figure. Candidate Obama promised an injection of roughly this scale. The result is likely to involve budget deficits in the range of 7-9% of GDP in many major economies, and this would be two to three times higher than the 3% ceiling which is often considered desirable over the entire cycle.



Table 2: Fiscal Conditions in the Major Economies

	Net Public Sector Debt Ratio (% of GDP 2008)	Budget Deficit (% of GDP 2008)
US	46.3	-4.1
Japan	94.3	-3.4
Germany	56.1	-0.3
France	55.5	-3.3
UK	37.6	-3.5

Note: The cost of an 'average' banking crisis might add 9% of GDP to net public debt. This would add about 0.5% to the net interest burden and therefore to the budget deficit. The costs of recession might add a further 3% to the budget deficit, making 3.5% in total. Any measures designed to ease fiscal policy would add to this. In total, it is not difficult to envisage a rise in budget deficits of around 4-5% of GDP for a while.

Source: IMF

These budget deficits will be far higher than would be consistent with stable public debt/GDP ratios, so they will inevitably involve some very rapid increases in such ratios. In addition, the government purchases of bank assets, and their injections of capital into the banks, will further add to debt ratios, even though they probably will not add to the budget deficits. (If bank assets are purchased at fair market prices, they will be seen as financial transactions, which are scored "below the line" of the public sector's operating deficit in most countries.) To judge from the half dozen banking crises in the post war era which are most similar to the present debacle, governments will need to spend at least 9% of GDP on below-the-line financial transactions to safeguard the banking sector. In fact, the total this time could turn out to be higher than this prior average. And it is improbable that all of this money will be returned to the government in the long term: past experience suggests that permanent losses are almost always incurred following state bail-outs of this kind.

When we add the impact of much higher budget deficits to the impact of the bank rescue packages, the increase in public sector debt ratios begins to look rather worrying. You do not have to make very pessimistic assumptions to conclude that the public sector debt ratio in the US could rise by about 14% of GDP in 2009, and by a further 10% in 2010, which would take the ratio up from about 46% to about 70% of GDP. If this is financed- in the normal way (i.e., by selling government bonds to the domestic non-bank sector and to foreigners), the net bond issuance would be three to four times higher than we have seen in the recent past. These are herculean increases, especially since they are likely to take effect in several economies simultaneously.

Apart from the long term effect of this extra debt on required tax yields and tax rates, there is a more immediate worry, which is that the sale of such enormous quantities of government debt will prove impossible without much higher bond yields. This would potentially be a very dangerous development for the global economy and the financial markets. However, it could be headed off by using the Bernanke technique of setting a ceiling on government bond yields and enforcing that ceiling by expanding the Fed's balance sheet



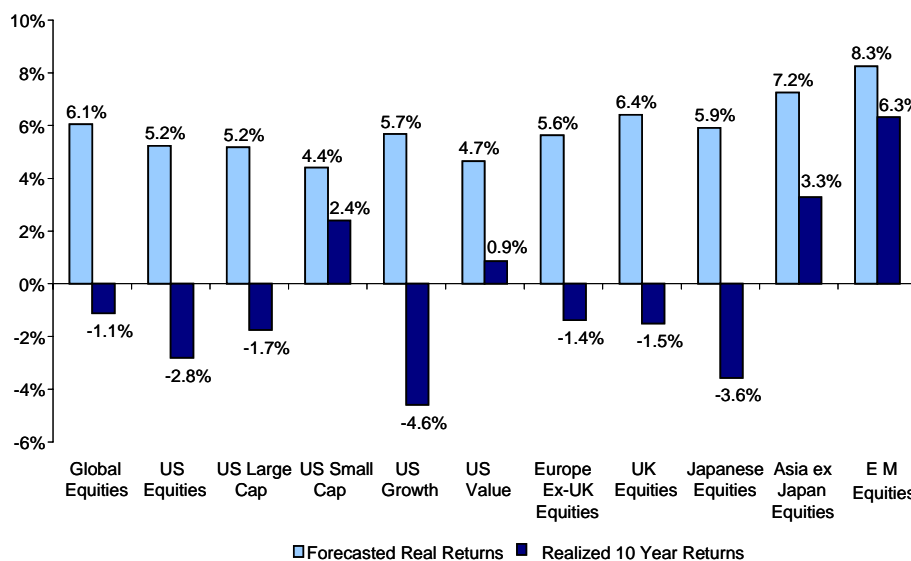
further to buy Treasuries. (In the decade prior to 1951, the Fed successfully set a ceiling on long term interest rates in the economy, at a time when government debt ratios were higher than they are today.) Such a policy would be absurdly dangerous in the inflationary era which all of us have inhabited during our lives, but it would be a necessary remedy if deflation took hold. My bet is that the Obama/Bernanke combo would be ready to take these extraordinary steps if needed, though recent evidence suggests that they may need to be forced into remedial action by seeing some further market disruption first.

Conclusion

Markets have in many cases “priced in” a very bad outcome for the global economy in 2009. US credit spreads are higher than they have been at any time since the war, and the S&P 500 index has now dropped below its long term trend for the first time since 1995, so it has (finally!) eliminated the long term overvaluation which developed from 1995-2000. Expected long term real returns on both equities and credit are therefore far higher than they have been in the last decade. Our latest estimates for long-term asset returns are shown in Graphs 9 and 10.

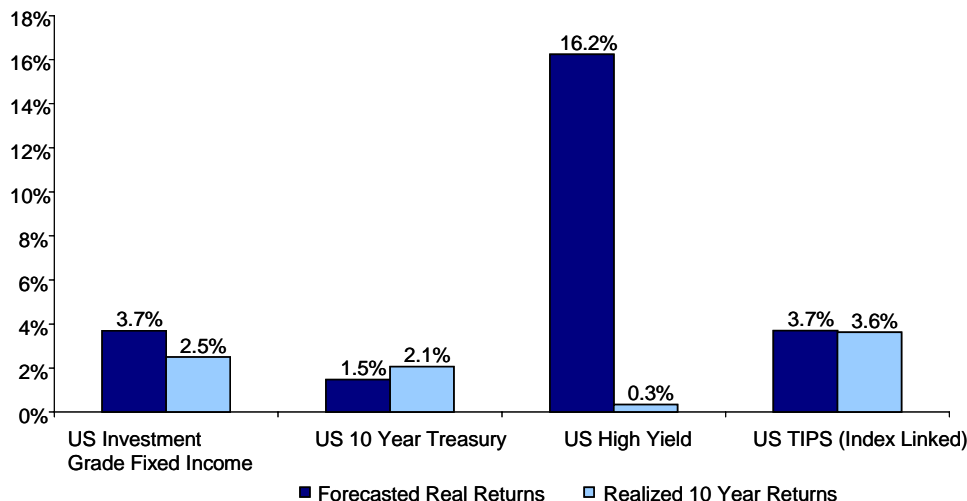
Graph 9 →

10 Year Realized and Forecasted Real Returns: Equities



Graph 10 →

10 Year Realized and Forecasted Real Returns: Fixed Income





In the shorter term, the markets still have to navigate the impact of collapsing economic activity, and it is difficult to state a definitive view on whether the equity and credit markets will record new lows in the months ahead. This needs to be continuously re-assessed and traded on an active basis. However, the 50%+ drop which we have already seen (from peak to trough) in global equities already marks this out as a very major bear market. A further lengthy and deep decline in equities and other risk assets would seem to be on the cards only if the present and future actions of policy-makers are thwarted, and the global economy falls into depression and deflation.

I take comfort from the fact that Ben Bernanke has a coherent plan to attack deflation if needed, and in Barack Obama he may have found a President who would back him to implement it in full. It may not be needed, let us hope not. But at least it is there.

Japan tried most of the suggested measures in the 1990s, but they did so grudgingly, introducing policy changes too slowly, and in inadequate doses. They also reversed the medicine every time it was just starting to work. Because the program was not introduced with sufficient gusto, it never really worked, and Japan remained mired in a relatively mild episode of deflation for about a decade. Japanese equities fell by 80% over two decades, and are still close to their lows.

In 1933, by contrast, the incoming US President Roosevelt introduced the New Deal with enormous vigor. It was an economic program which ironically had little connection with what he had promised during his victorious election campaign. During the campaign, he painted himself as a man of fiscal caution and probity. Afterwards, he increased counter-cyclical government spending, and devalued the dollar against gold by 40% in 1933-34, backing this with a surge in money creation by the Federal Reserve. Deflation disappeared very quickly, with the rate of consumer price inflation rising from -10.3% in 1932 to +3.4% in 1934. GDP grew by 11.1% in real terms in 1934. And the stock market rose by 79% in the 12 months following Roosevelt's inauguration. Bernanke reckons, with justification, that "if nothing else the episode illustrates that monetary actions can have powerful effects on the economy, even when the nominal interest rate is at or near zero."

Politically, who does Barack Obama resemble more: the Japanese political leaders of the 1990s, or Franklin Delano Roosevelt? We may soon find out.

Gavyn Davies
November, 2008



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