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Green lights predominate in a survey of the economic scene. Employment is up, consumer spending and asset prices are rising, and activity in the US, China, and a broad swath of the rest of the world is expanding. But the outlook is murky: Japan has announced a plan to deliberately cheapen their currency in the world markets, hoping to encourage exports, end a lengthy deflation, and turn it into a mild inflation.

Several European countries are suffering from past financial misbehavior. Even now, while our economy is emerging from the collapse of the last real estate wave, the Federal Reserve is spending \$85 billion a month to purchase mortgages and US government debt, at a rate of about a trillion dollars a year. Beyond reducing interest rates for borrowers, the resulting expansion of liquidity creates other effects. It deprives the most elemental of investors, passbook savers, of ordinary interest earnings and causes assets such as land and houses to rise in price. As a result, pools of capital have been forming for the purpose of speculating in portfolios of farmland and single family houses.

An alternative policy would be to reduce government outflows by disciplining spending and reshaping unupportable promises in Social Security, Medicare, Medicaid, and public pensions. That, however, is not in accord with the policy of our present government.

If and when interest rates are allowed to return to market levels, prices of long term bonds are going to decline painfully; that is why we have avoided them, but the condition at hand now is the self-caused economic suppression of Europe and Japan and moderate growth elsewhere. Those two broad forces interacting in the financial markets will determine the ebb and flow of values and returns in the next couple of years.

The oft-predicted acceleration of inflation has not become evident, encouraging the notion that it's a good idea to flood a weak economy with liquidity so as to stimulate a return to economic vitality; besides, it's painless and seemingly cost free. Our understanding is that inflation is unavoidable when you do the things we are doing, but its arrival can be postponed by economic malaise. Rather than a burden to be abolished, inflation probably ought to be seen for what it really is: an unavoidable effect of a tendency of human behavior. Inflation, then, is a tool which can erode national debt by cheapening the currency which was borrowed and owed. The phenomenon is experienced by the broad public without much distress while the truly painful damage is sustained by those who invest expensive money only to be repaid with a cheapened version.

The ethics of the thing are shabby but it would cope with unaffordable pensions and social safety nets, as the promised payments could be whittled down to affordable levels. We would not prefer it, but it might be the best achievable resort. But first, pensions must not be indexed for inflation.

One important news subject is North Korea in which the new leader is provoking fear and anger by threatening war, presumably in hope of rewards in the form of material goods and world respect. The drama includes American and South Korean forces displaying military might in response to provocations, while China deploys men and material on its border with Korea, both to forestall an attack

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on the North and to control the potential flow of population escaping starvation by migration into China. We have no advice to offer, but cannot help reflecting on what a boon to mankind it would be upon the destruction, simultaneously, of the nuclear facilities in Iran and North Korea.

A second news focus is the financial impact on Cyprus of the investment losses suffered by its banking system. Although little has been disclosed about the nature of the failed investments, the losses are being relegated where they should be: to the owners, lenders, and uninsured depositors of the banks, and not the citizens of the nation. The importance of the news is the relevance to the southern tier of European states, all of which are in bad financial condition. We have not yet seen a plan which would enable a return to health except by reducing social support programs to amounts that can be taken from the production of the economy without resort to borrowing.

If Germany agreed to take financial responsibility for the whole European Union, that would kick the can a few years down the road, would reduce the potential for fear-driven flight of capital out of Europe and into the US which, in turn, would exaggerate prices of American assets such as real estate and stocks and further depress the European economy. In such a set of events, growth worldwide would probably be sluggish for a few years.

Although we do not know which escape from financial jail will ensue, we are comforted that the assets best able to withstand pressure will be the ones already in use, while also being reminded that long term debt carrying an interest rate of 3% or 4% is cheap and borrowers would benefit by the ease with which debt can be carried during an inflationary period, assuming the debts are of a comfortable amount.

The major unknown is the direction of future financial policy here in the US, and as it evolves in China, Japan, and Europe. As always, we will be interested observers.

Sincerely,

John May