CURRENCY CURRENTS

A free global-macro & market newsletter

BLACKSWAN

Monday 11 February 2013

Quotable

"Most games are lost, not won."

Casey Stengel

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Currency Currents Professional

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You are cordially invited to join **Tres Knippa**, President of Kenai Capital Management, and **Jack Crooks**, President of Black Swan Capital, for a complete global-macro analysis of the major themes they believe will drive currency and bond trading in Japan over the next year and beyond.

They both believe there are incredible opportunities you can position for now.

JAPAN: The Path of Debt and Currency Markets

Wednesday, February 13 at 04:00 PM EST

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Commentary & Analysis

In the tale of two economies, gold could suffer.

Summary:

It seems to me ongoing government and central bank "stimulus" is hampering the ability of the economy to generate real growth. This may be the catalyst for a long period of "low inflation" and rising unemployment while, at the same time, the stock market works higher and higher as it becomes increasingly detached from the real economy to a degree we have not witnessed before ... thus perpetuating an economic environment already taking hold in America. One characterized by those with access to capital who are quite happy and those without who are growing increasingly unhappy.

Trade Idea:

In a slow-growth "muddle through" low-inflationary world whereby financial assets are valued higher than real assets (as seen in the continued rise in the S&P/CRB ratio), the US dollar looks relatively attractive against its main rival the euro, **it could mean a broader sell-off in gold than is now imagined.**

Ah, all is right in the world.

No, I'm not talking about a new high in stocks, though that is pretty good. I am talking about pitchers and catchers report this week to spring training.

But all isn't right in the world if you earn your living as Joe Six Pack in the real economy.

Granted, there are some signs of encouragement. But there seems little confidence it will be sustained.

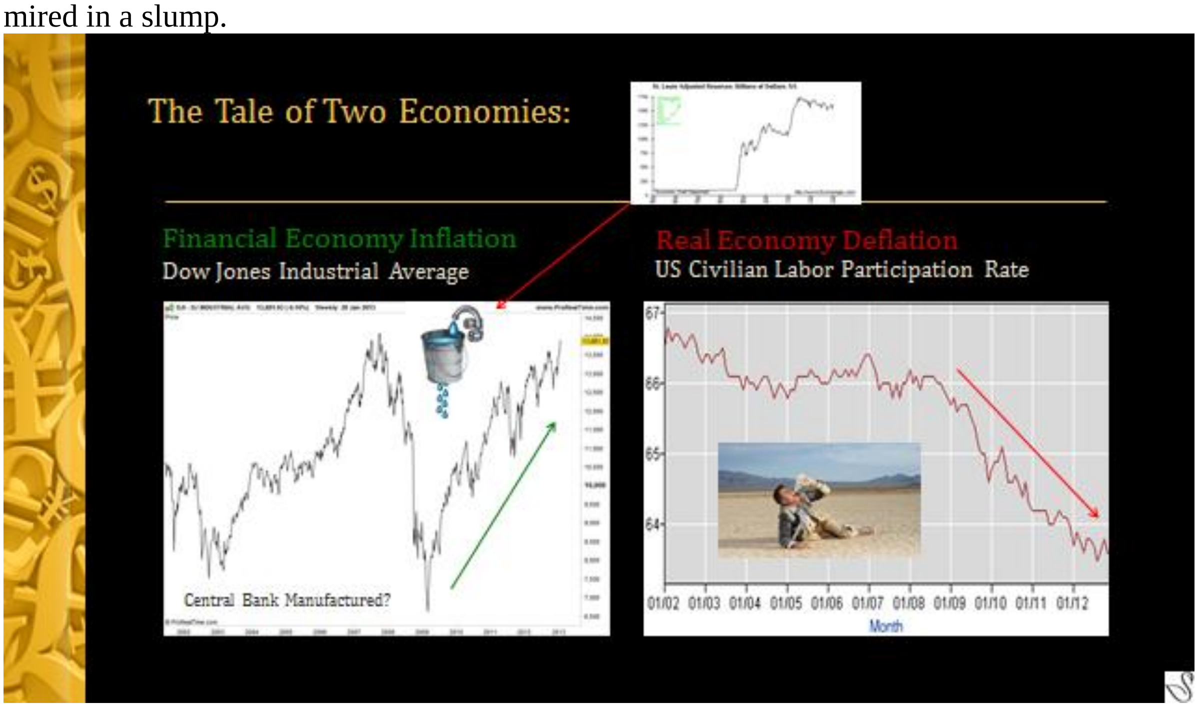
Much of the money the Fed has created is no doubt "leaking" into financial assets. But why isn't it "leaking" into the real economy, and when are we going to see a positive feedback loop from stocks into the real economy? Or, if we've seen positive feedback already, should we probably be a bit concerned?

I think about these questions as the right answers will likely give you a leg up on key asset class direction. But in a world where monetary and fiscal policy has gone completely askew relative to historical precedence, confidence in one's answers is fleeting at best.

I think the burden of too much public debt is the key to how the future unfolds, as I believe it is zapping the lifeblood of the economy, i.e. the road to hell is paved with good intentions. If you have some thoughts, please feel free to send your ideas to us at info@blackswantrading.com. We would like to share them with our readers.

In the chart below, I juxtaposed the stock market against the labor participation rate (which we generally think is a better representation of the labor market than non-farm payrolls or the official unemployment rate) so you can visualize the dramatic difference in paths.

Financial assets (stocks) have their rally caps on, while the real economy (labor) remains mired in a slump.



That little box at the top and set off to the right, shown in the chart above, represents US banking reserves. They have soared about 1800% since the credit crunch. Now if you were told that would happen, before it actually did, you likely would have expected runaway inflation. And you would have been very wrong. It seems the weight of the money has produced inflation in financial assets, but we've seen little in the real economy.

I know what you are thinking ...

If there is no inflation in the real economy why are energy, medical, food, and education costs rising? Isn't that inflation? Good question.

If we accept the real definition of as "a decline in the purchasing power of your money," which is often stated as "too much money chasing too few goods" we have to also consider whether this latter definition is in effect.

I think a simpler way to say the same thing: If real income does not go up, a rise in the price of one item means you buy less of another.

So, rising prices of food and energy et al, stuff we all need to buy, transfers wealth to the food and energy industries and withdraws wealth from other industries, i.e. less discretionary spending as the economists call it. This transfer of money from the same size pool of money isn't inflationary.

Thus, when government mandated costs rise—Obama Care, higher taxes, regulation, and compliance—and incomes don't rise, then the demand for private market goods tends to fall.

The question and concern is that sooner or later the weight of all that money in the system will come rushing into the real economy and bid up inflation when a recovery takes hold.

That makes sense.

But given all that has been done and is still being done on the monetary and fiscal policy side, why hasn't a more vibrant recovery already taken hold? That's the big question.

Is it just another $500 billion more QE at the margin that will do the trick? Or another so-called "jobs bill" from government? Maybe the two together will finally kick the economy into gear.

Why would it?

I think the whole notion of monetary and fiscal policy is extremely flawed. I think it is making the economy increasingly less vibrant with each and every dollar of public money thrown onto the market.

Have we ever witnessed private and public debt levels relative to US GDP as high as they are now? No. Is it as simple as not letting the market clear?

And why will a US debt crisis necessarily lead to a Weimar Republic-like hyperinflation?

Isn't it just as possible such an overwhelming write-down of debt leads to a massively crushing deflation as the relatively massive supply of dollars compared to the real economy is taken off the board?

Or the other alternative is this ...

Central banks for the next several years continue to act as pure political conduits of their respective governments. Those with the ability to harness the massive supply of reserves—rich folks, fund managers, financial institutions, etc.—continue to bid up the value of financial assets. Those in the real economy become continually less productive as the burden of debt continues to soar. The US public debt is now only around 103% of GDP; we have a long way to go to catch up with Japan.

This scenario financially seems to fit with the rising cultural and real income balkanization of the US defined by those with access to capital versus those without.

So more and more capital (credit) or whatever is chasing the same amount of listed financial assets—stock market inflation—while less capital for new ventures and entrepreneurial activity leads to lower labor participation and falling real incomes for those in the real economy. Is this what the divergence in stocks versus commodities is telling us?

DBC PowerShares Commodity Index

S&P 500 Futures Index

So it is to say that financial assets will be valued above real assets in a slow-growth low-inflationary environment where it appears, despite all the inherent warts, the US dollar could remain well-supported relative to its key challengers—the euro and the yen.

In such a world, one key asset class could be setup for a deeper fall than now anticipated: gold.

Our *Global Investor* members have been short for a while and we still like the trade.

Stay tuned.

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