

GLOBAL FOCUS

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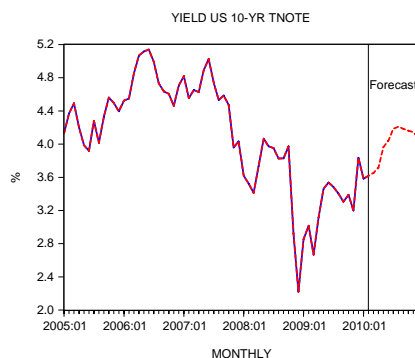
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The strength of an economy and recessions - are they connected?

Contrary to the popular view recessions are not about the weakness of an economy as such but about the liquidation of various activities that sprang up on the back of the previous loose monetary policies of the central bank. Once, however, the central bank tightens its stance this slows down the diversion of real savings from wealth producers to non-wealth producers. Activities that sprang up on the back of the previous loose monetary policy come under pressure – an economic bust, or recession emerges. We suggest that a visible fall in the growth momentum of real AMS poses a threat to US real GDP in quarters ahead. Also the fact that currently banks are finding it unattractive to engage in lending raises the likelihood that the pool of real savings is in trouble. Year-on-year commercial bank lending fell by **10.1%** in February after declining by **9.4%** in January. For the time being the effect from the past strong money supply rate of growth continues to push various US economic data higher. However the current fall in the growth momentum of AMS is starting to undermine some economic data such as housing. Meanwhile major central banks have raised the pace of money pumping. A visible fall in the growth momentum of monetary liquidity in countries such as Russia, Brazil and India poses a threat to these countries stock markets.

KEY GRAPH

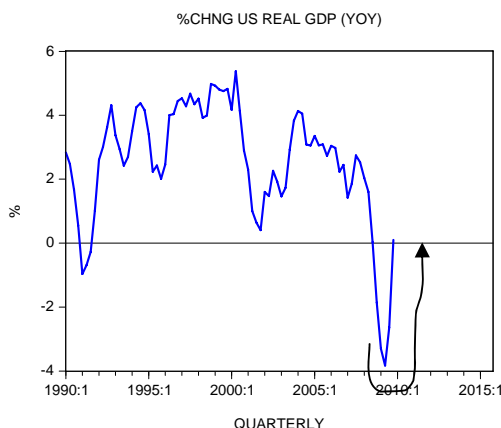


Eco-flash

According to our model the yield on the US 10-year Treasury Note could rise to **4.2%** by July from **3.62%** at the end of February (p 10)

Does strengthening in real GDP points to healthier US economy?

US real GDP increased at an annual rate of **5.9%** in Q4 after rising by **2.2%** in Q3 – the quickest pace in more than six years. The yearly rate of growth of real GDP climbed to **0.2%** in Q4 from minus **2.6%** in Q3.



In response to the strong GDP data many economists have hailed the Q4 data as the most positive news on the economy so far. Observe that most economists regard recessions as a sudden weakening in the economy predominantly on account of a decline in the overall demand for goods and services. Hence it is held that once the economy has fallen into a recession it is the job of the central bank to pull it out of the recessionary hole. The means that are always recommended is the lowering interest rates and raising the rate of growth of money supply. The loose monetary stance of the central bank energizes the so called economy thus permitting it to commence an economic recovery, so it is held.

Recessions however, are not about the weakness of an economy as such but about the liquidation of various activities that sprang up on the back of the previous loose monetary policies of the central bank.

A loose central bank monetary policy sets in motion an exchange of nothing for something, which amounts to a diversion of real wealth from wealth generating activities to non-wealth generating activities. In the process this diversion weakens wealth generators and this in turn weakens their ability to grow the overall pool of real wealth.

The expansion in the activities that sprang-up on the back of loose monetary policy is what an economic “boom”, or false economic prosperity, is all about. Observe that once the central bank’s pace of monetary expansion has strengthened, irrespective of how supposedly strong and big a particular economy is, the pace of the diversion of real wealth is going to strengthen.

Once, however, the central bank tightens its monetary stance, this slows down the diversion of real wealth from wealth producers to non-wealth producers. Activities that sprang-up on the back of the previous loose monetary policy are now getting less support from the money supply they fall into trouble – and an economic bust, or recession emerges.

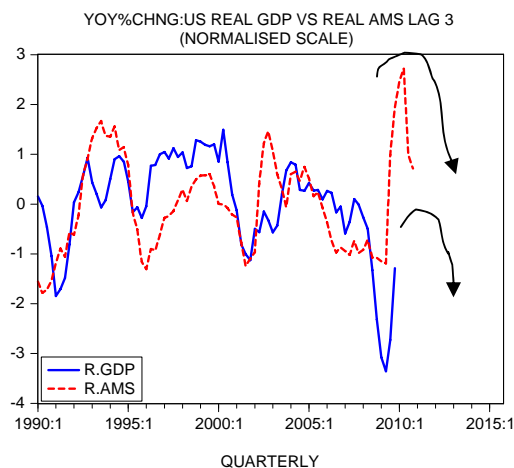
Irrespective of how big and strong an economy is, a tighter monetary stance is going to undermine various un-economic activities that sprang-up on the back of the previous loose monetary policy. This means that recessions or economic busts have nothing to do with the so-called strength of an economy, improved productivity, or better inventory management by companies.

For instance, as a result of a loose monetary stance on the part of the Fed various activities emerge to accommodate the demand for goods and services by the holders of newly printed money. Even if the newly emerged activities are well managed and maintain very efficient inventory control, this fact cannot be of much help once the central bank reverses its loose monetary stance. Note that these activities are the product of the previous loose monetary stance of the central bank.

Once the stance is reversed, regardless of efficient inventory management, these activities will come under pressure and run the risk of being liquidated.

Note that GDP is designed along the lines of Keynesian thinking, which holds that monetary spending equates with income – hence more money leads to a higher national income and in turn to higher economic growth.

Over time movements in real GDP are driven by movements in money supply adjusted for price inflation i.e. real AMS. We suggest that a bounce in the growth momentum in real GDP is due to the past massive money pumping by the Fed. A visible fall in the growth momentum of real AMS poses a threat however to the growth momentum of real GDP in quarters ahead. (Note that the AMS series in this chart excludes the supplementary financing program of the Treasury).



Since the present strengthening in the growth momentum of real GDP is on account of past massive money pumping, and since money pumping is bad for wealth generation, it follows that a strong real GDP rate of growth is actually bad news for the economy's fundamentals. (Remember more money weakens wealth generators' ability to grow the economy).

From this it follows that an expected weakening in the growth momentum of real GDP on the back of the falling growth momentum of real AMS implies a strengthening in the wealth generating process.

As long as wealth producers can generate enough real wealth to support productive and non-productive activities loose monetary policies will appear to be successful.

Irrespective whether an activity is productive or non-productive it must be funded. At any point in time the number and the size of activities that can be undertaken is determined by the available amount of real savings.

Over time a situation can emerge where as a result of persistent loose monetary and fiscal policies there are not enough wealth generators left. (Wealth generators have been badly damaged by loose policies).

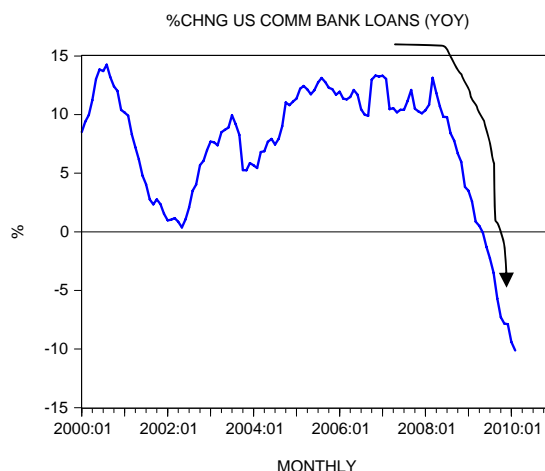
Consequently, generated real savings are not large enough to support an increase in economic activity. Once this happens the illusion of loose monetary and fiscal policies is shattered – real economic growth must come under pressure.

Even in terms of GDP it will be difficult to show economic growth. (The only reason why in such an event GDP could supposedly grow is on account of the employment of misleading price deflators).

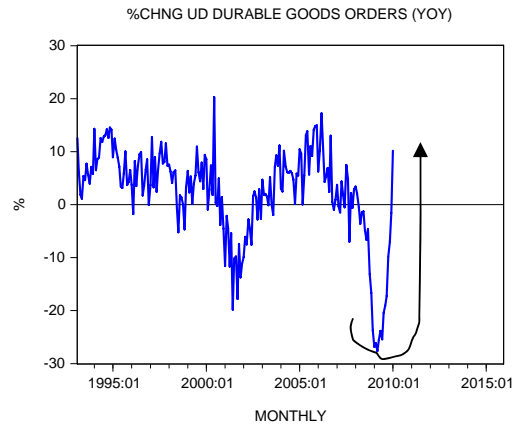
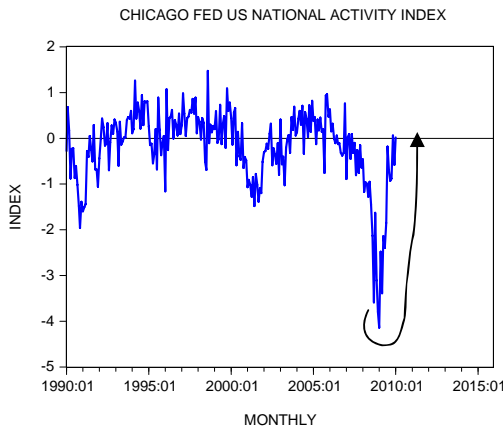
A fall in bank lending raises the likelihood that the pool of real savings is under severe pressure. (Remember that ultimately bank lending is dictated by real savings and not by the monetary pumping of the Fed).

The fact that currently banks are finding it unattractive to engage in lending also points to the possibility that the pool of real savings is in trouble.

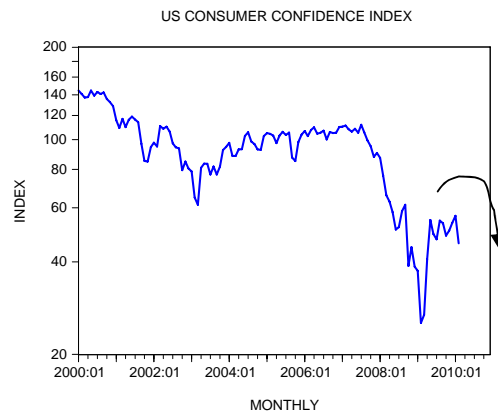
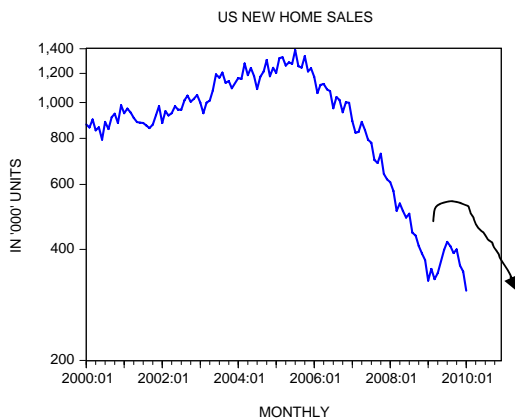
The latest data indicates that banks are still very tight. Year-on-year so far in February commercial bank lending fell by **10.1%** after declining by **9.4%** in January. This was the 10th consecutive monthly decline.



Apart from GDP the strong past money supply rate of growth is also driving other economic data higher. The Federal Reserve Bank of Chicago reported that its gauge of the national economy rose to plus **0.02** in January from minus **0.58** in December. The Chicago Fed said that the gauge raises the likelihood that the growth in the national economic activity is beginning to near its historical trend. Also the growth momentum of durable goods orders increased sharply last month. The yearly rate of growth climbed to **10.2%** from minus **1.6%** in December.



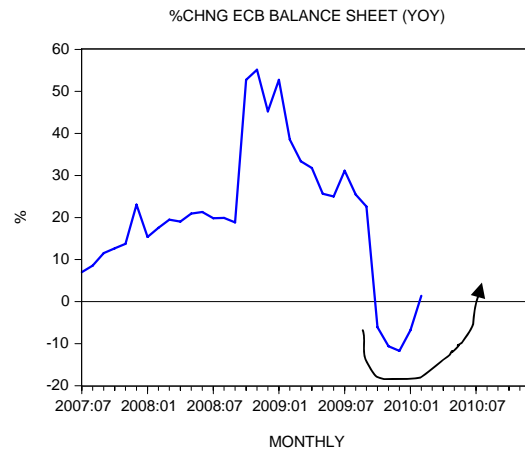
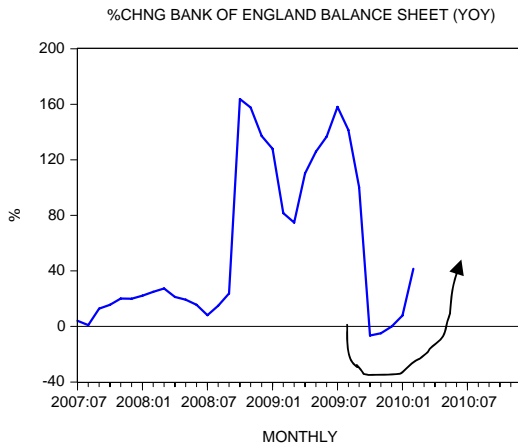
A sharp fall in the growth momentum of AMS during August 2009 to December 2009 is starting to undermine some activities (with a shorter time lag effect from money supply) that emerged on the back of the previous strong money rate of growth. Note that these activities, or bubble activities, are in every part of the economy. It is for this reason that once these activities come under pressure economic activity in general tends to follow suit. Sales of new homes fell by **11.2%** in January to an annual rate of **309,000** units, from **348,000** units in December. Existing home sales have also weakened last month, falling by **7.2%** from December. Furthermore, consumer confidence fell in February to the lowest in 10 months. The confidence index fell to **46** in February from **56.5** in the month before. The present situation index fell to **19.4** from **25.2** in January, the worst since February 1983.



Major central banks have raised the pace of money pumping

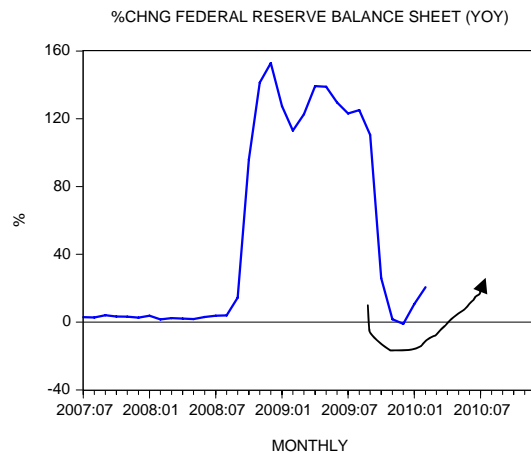
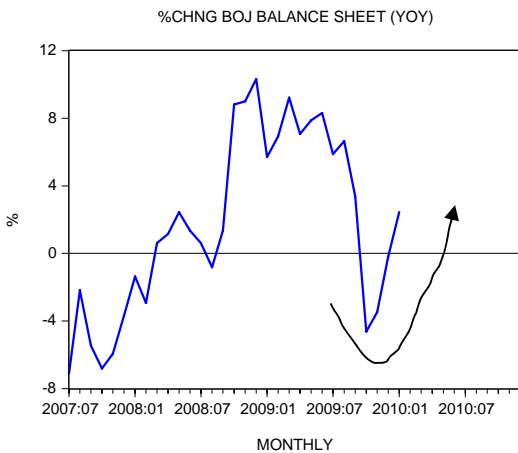
The Bank of England (BOE) balance sheet has been strengthening since October last year. The yearly rate of growth jumped from minus **6.6%** in October to plus **41.4%** so far in February. In January the yearly rate of growth stood at **7.9%**. Note that the yearly rate of growth climbed to **158.1%** in July last year.

Also the European central bank has eased its monetary stance. After falling to minus **11.7%** in December last year the yearly rate of growth of the balance sheet climbed to **1.4%** so far in February. Observe that the yearly rate of growth stood at **52.8%** in January 2009.



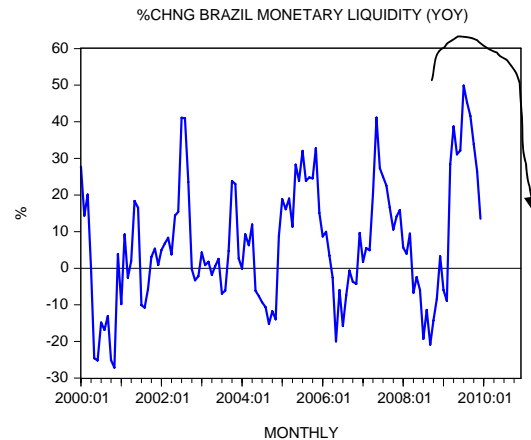
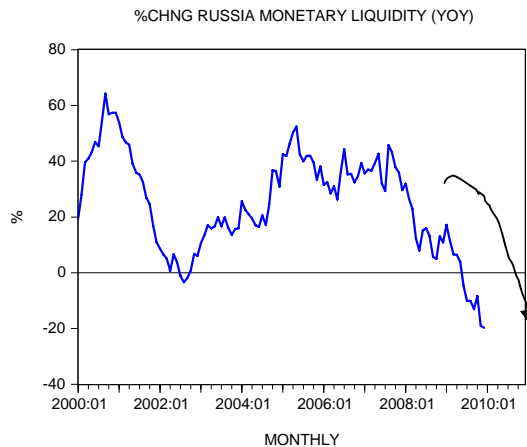
The growth momentum of the Bank of Japan (BOJ) balance sheet also displays a visible strengthening. Year-on-year the rate of growth jumped from minus **4.6%** in October last year to **2.4%** in January.

The growth momentum of the Federal Reserve balance sheet also displays a visible strengthening. The yearly rate of growth of the Fed's balance sheet jumped to **20.6%** so far in February from **10.6%** in January and minus **1.1%** in December.

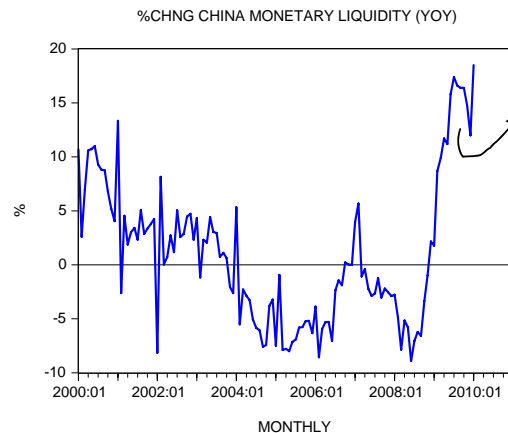
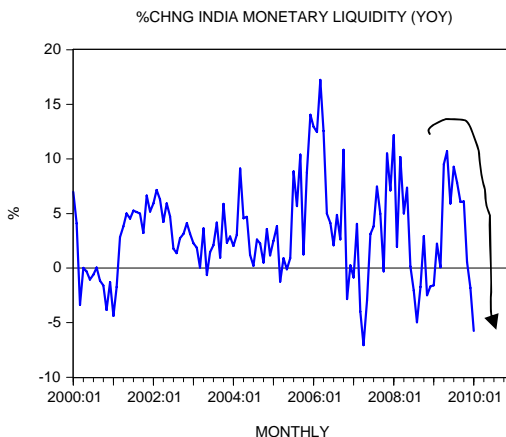


Focus on emerging markets monetary liquidity

The growth momentum of Russia's monetary liquidity displays a strong decline. After closing at **17.2%** in January last year the yearly rate of growth of Russia's monetary liquidity plunged to minus **19.7%** in December. A major factor behind the collapse in liquidity is a fall in the yearly rate of growth of AMS from **14.6%** in January 2009 to minus **8.2%** in December 2009. A strong increase in the growth momentum in Brazil's industrial production coupled with a softening in the yearly rate of growth of monetary measure AMS resulted in a decline in the growth momentum of Brazil's monetary liquidity. The yearly rate of growth of liquidity stood at **13.5%** in December against **26.5%** in the previous month and **49.9%** in July 2009.

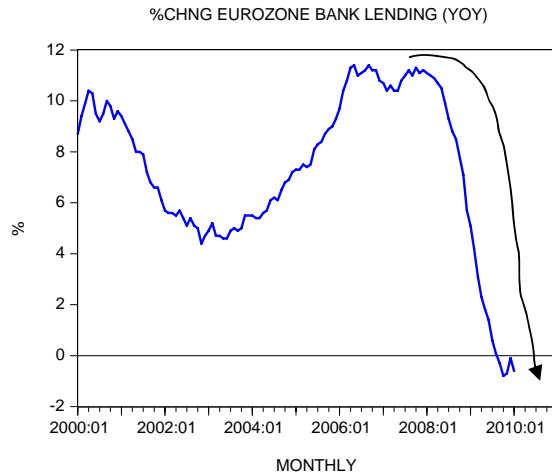
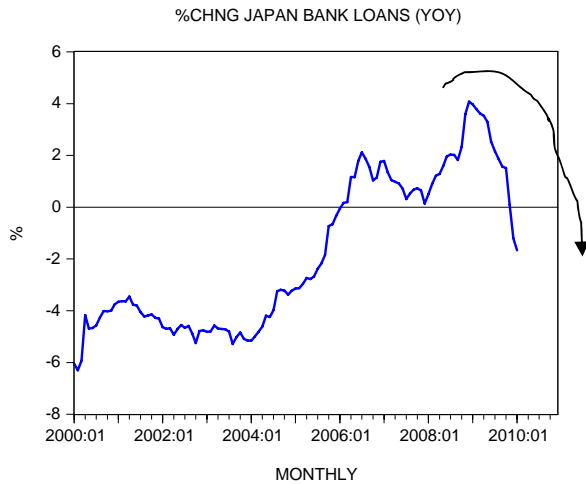


A softening in the growth momentum of our monetary measure AMS coupled with the acceleration in price inflation and a still buoyant rate of growth in industrial production has resulted in falling growth momentum of India's monetary liquidity. Year-on-year the rate of growth of liquidity fell to minus **5.8%** in January from minus **1.8%** in the month before and **10.7%** in May last year. In contrast, on account of the acceleration in the growth momentum of money M1 the growth momentum of China's monetary liquidity has visibly risen in January. The yearly rate of growth of China's monetary liquidity stood at **18.5%** in January against **12%** in December and **1.8%** in January last year.

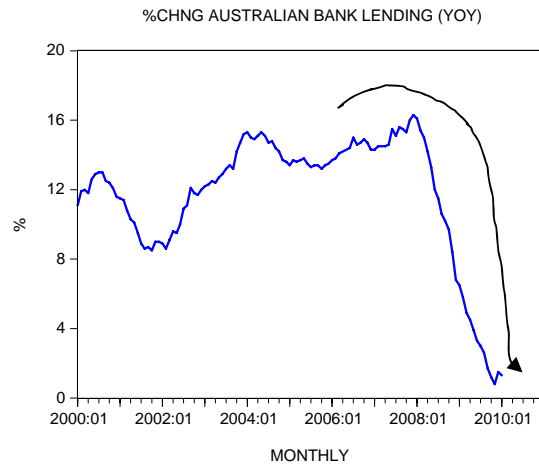
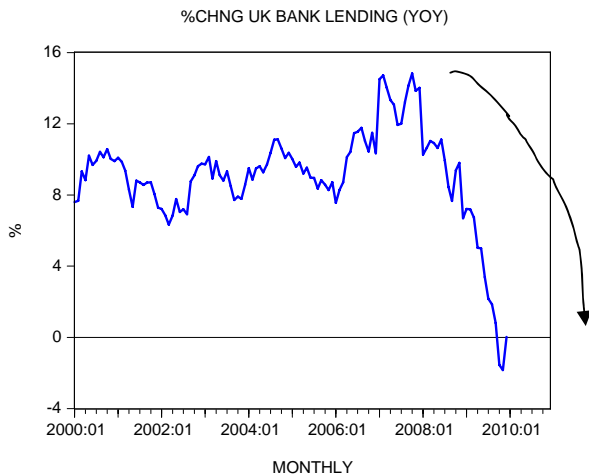


Focus on non – US economies bank lending

The growth momentum of Japan's bank lending is in a steep decline since December 2008. After closing at **4.1%** in December 2008 the yearly rate of growth of lending fell to minus **1.7%** in January. Note that in December the rate of growth stood at minus **1.2%**. Also the growth momentum of bank lending in the Euro-zone displays a visible decline. Year-on-year the rate of growth fell to minus **0.6%** in January from minus **0.1%** in the previous month. This was the 5th consecutive monthly decline.

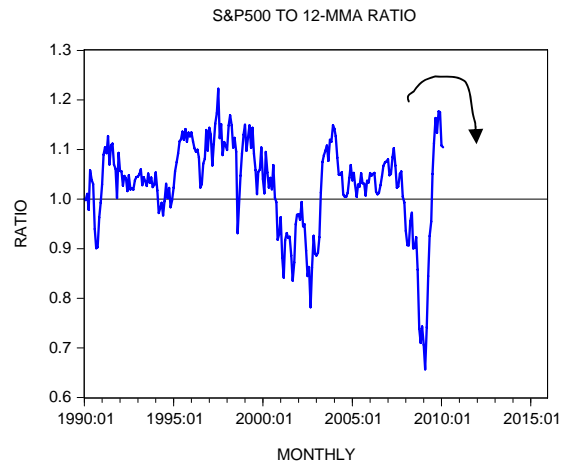
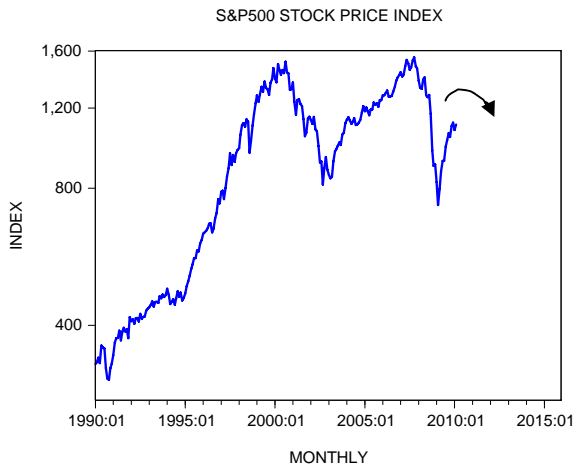


In the UK the growth momentum of bank lending also remains subdued. The yearly rate of growth of lending stood at **0%** in December last year against minus **1.8%** in November and minus **1.5%** in October. Note that in December 2008 the yearly rate of growth stood at **6.7%**. In the meantime the yearly rate of growth of bank lending in Australia eased to **1.3%** in January from **1.5%** in the month before. In January last year the yearly rate of growth stood at **6.5%**.

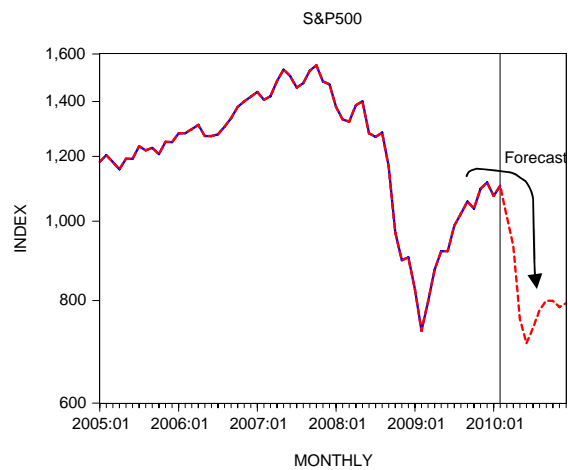
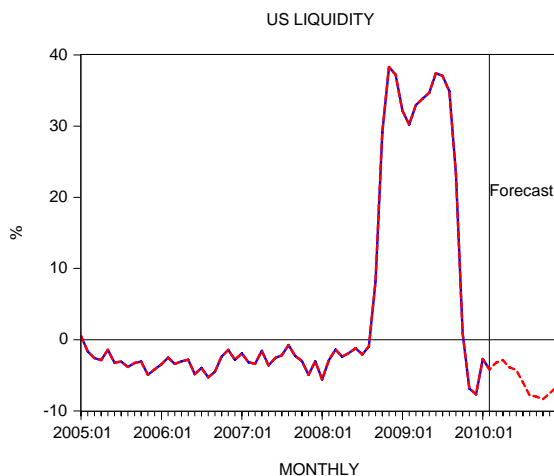


US stocks up strongly in February

For the week the Dow Jones Industrial average was off **0.8%**, the S&P500 was down **0.4%** and the Nasdaq lost **0.3%**. For the month of February, the Dow ended **2.6%** higher, the S&P500 rose **2.9%** and the Nasdaq climbed **4.2%**. Year-on-year the rate of growth of the S&P500 jumped to **50.3%** from **30%** in January. The S&P500 to its 12-month moving average stood at **1.104** against **1.108** in January. From this perspective the stock price index is overvalued.

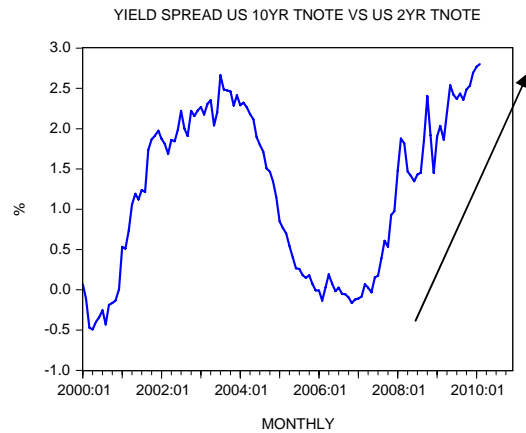
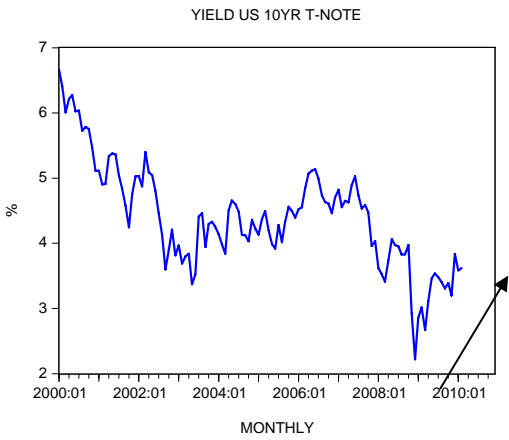


We continue to assume that the Fed is likely to start withdrawing money from the economy in a few months time. This coupled with a relatively strong economic activity and rising price inflation, should put downward pressure on monetary liquidity. We forecast that the yearly rate of growth of liquidity will fall to minus **8.4%** by October from minus **2.7%** in January. By December the rate of growth is forecast to settle at minus **6.6%**. According to our model the S&P500 index is poised to come under pressure in the months to come. By June the index could fall to **710**. Afterwards the stock price index is forecast to rally to **800** by October. In December the index is forecast to settle at **790**.

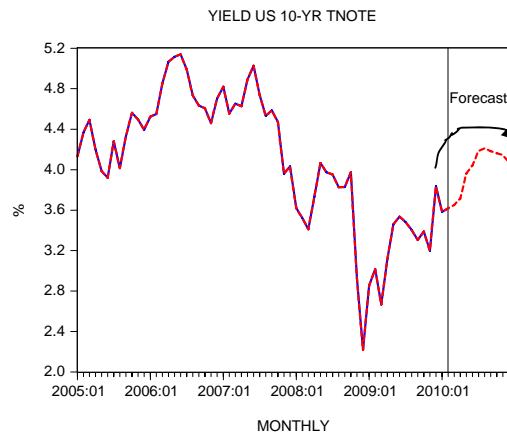
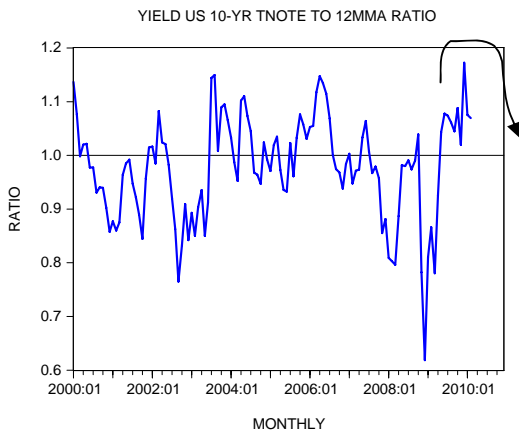


US Treasury yields fell on Friday

The yields fell on Friday after news that home sales fell in January and consumer sentiment slipped in February reinforced expectations for subdued economic growth this year. The yield on the 10-year T-Note closed at **3.617%** a fall of **0.159%** from a week ago. At the end of January the yield stood at **3.58%**. The 2-year T-Note which is sensitive to changes in the federal funds rate fell to **0.816%** on Friday from **0.92%** a week earlier. For the month the yield was unchanged. The yield spread between the 10-year and the 2-year T-Note closed at **2.8%** against **2.77%** in January. Adding to the supportive tone for Treasuries last week was the testimony by Bernanke in which he suggested that the Fed will maintain the current low interest levels for an extended period of time.



The “TED” spread stood at **0.130%** against **0.17%** at the end of January. The spread is the difference between the three month rate to borrow US dollars in the London inter-bank market and the rate on the three months US T-bill. The ratio of the yield on the 10-year T-Note to its 12-month moving average eased to **1.07** from **1.075** at the end of January. As long as the ratio is above **1.0** we can suggest that the 10-year T-Note relative to its 12-month moving average is in an under valued area. According to our model the yield on the 10-year T-Note is forecast to rise to **4.2%** by July. By December the yield is forecast to ease to **4.1%**.



Does diversification reduce investment risk?

According to the efficient markets hypothesis, stock market prices move in response to new, unexpected information. Since, by definition the unexpected cannot be known, it implies that an individual's chances of anticipating the general direction of the market are as good as anyone else's chances.

It is thus suggested that since the future direction of the stock market cannot be known the only way of earning above average returns is to assume greater risk. This is described by the modern portfolio theory (MPT). It is accepted by the practitioners of this theory that risk is associated with the degree of dispersion of returns around the average of returns.

A security whose returns are not expected to deviate significantly from its historical average is termed as a low risk. A security whose returns are volatile from year to year is regarded as risky. MPT assumes that investors are risk averse and they want high guaranteed returns. To comply with this assumption the MPT instructs investors how to combine stocks in their portfolios to give them the least possible risk consistent with the return they seek. MPT shows that if an investor wants to reduce investment risk he should practice diversification.

Consider the following simple example:

	Activity A	Activity B
Cold Weather	20%	-10%
Warm weather	-10%	20%

Let us assume that on average, half of the time the weather is cold and half of the time it is warm. According to the table, investment in activity A will yield a 20% return in cold weather and in warm weather will produce a loss of 10%. On average the return by investing in A will be 5%. The same outcome will be obtained with regard to investment in activity B.

The MPT then suggests that if an investor diversifies and invests one dollar in A and one dollar in B then he will be guaranteed a 5% return regardless of weather conditions. Thus in warm weather, one dollar invested in B will produce a 20% return, while one dollar invested in A will produce a 10% loss. Investors total return on two dollars invested in A and B will be 5%. Exactly the same result will be obtained for cold weather conditions. This example illustrates that through the magic of diversification regardless of weather conditions one can obtain risk free 5% return on investment.

This must be contrasted with the fact that the two investments A and B are highly risky, because the frequency of a cold or a warm season in a particular year cannot be always ascertained. All that we know is that on average, over a prolonged period of time, half of the time the weather is cold and half of the time it is warm. This however, doesn't mean that every year this will be so. This example shows that as long as activities are affected differently by given factors there is a place for diversification, which will eliminate risk.

The basic idea of MPT is that portfolios of volatile stocks, i.e. risky stocks, can be combined together and this in turn will lead to the reduction of the overall risk. The guiding principle for combining stocks is that each stock represents activities that are affected by given factors differently. Once combined, these differences will cancel each other out, thereby reducing the total risk.¹ In short, with diversification, one can achieve higher levels of return without exposing himself to greater risk. This is because of the fact that not all asset prices move in tandem with one another – asset prices not perfectly correlated. Price movements in one asset in a portfolio offset price movements in another asset.

Now the MPT indicates that the risk of various stocks must be broken into two parts. The first part is associated with the tendency of returns on a stock to move in the same direction as the general market. The other part of the risk results from factors peculiar to a particular company. The first part of the risk is labeled systematic risk, the second part, unsystematic. Through diversification only unsystematic risk is eliminated, systematic risk cannot be removed through diversification. Consequently it is held that return on any stock or portfolio will be always related to the systematic risk, i.e. the higher the systematic risk the higher the return.

The systematic risk of stocks captures the reaction of individual stocks to general market movements. Some stocks tend to be sensitive to market movements while other stocks display less sensitivity. The relative sensitivity to market moves is estimated by means of statistical methods and is known as beta. In this regard beta is the numerical description of systematic risk. If a stock has a beta of 2 it means that on average it swings twice as much as the market. Thus if the market goes up 10% the stock tends to rise 20%. If however, the stock has a beta of 0.5 then it tends to be more stable than the market.

Does it make sense?

The popular view that through diversification investors are likely to safeguard their money and secure a good return has proven to be false in the present financial turmoil when asset prices actually moved in one direction i.e. down. Stocks, corporate bonds and assets backed by mortgages have been hit badly². Hence despite the spreading of money across different assets investors have found that they weren't protected as the MPT promised them.

We suspect that an important factor in all of this is the existence of bubble activities. Once the Fed tightens its stance or a perception emerges that liquidity could get tighter pressure on various bubble activities ensues. Now bubble activities may be in every sector of an economy. Hence when a tighter monetary stance poses a threat to a bubble activity in one sector it is also a likely threat to bubbles in other sectors of the economy. Furthermore, even non-bubble activities may come under pressure. For instance, to stave off bankruptcy investors are likely to dispose of good assets like gold in order to secure cash and in the process depress the price of gold. The MPT framework gives the impression that there is a difference between investing in the stock market and investing in a business. However, the stock market doesn't have a "life of its own". The success or failure of investment in stocks depends ultimately on the same factors that determine the success or failure of any business. Consequently an investment in stocks should be regarded as an investment in business as such and not in stocks. By becoming an investor in a business an individual has exercised an entrepreneurial activity. In other words he has committed his capital

¹Burton G. Malkiel (1996), *A Random Walk Down Wall Street*, New York.

² A Diversified Portfolio May Not Be Good Enough –The Wall Street Journal August 6, 2007.

with a view to supply the most urgent needs of consumers. For an entrepreneur the ultimate criterion for investing his capital is to employ it in those activities that will produce goods and services that are on the highest priority list of consumers. It is this striving to satisfy the most urgent needs of consumers, that produces profits and it is this alone that guides entrepreneurs.

The entrepreneurs focus and main consideration while investing his capital is to secure the highest possible profits, not to minimise risk as the MPT suggests. If entrepreneurs strived after what they considered to be the safest investment while neglecting consumers wishes they would render the entire investment unsafe. It is questionable whether higher return is on account of more risk as suggested by MPT. The size of an entrepreneur's return on their investment is determined not by how much risk they assume, but whether they comply with consumers' wishes.

According to Mises:

A capitalist never chooses that investment in which, according to his understanding of the future, the danger of losing his input is smallest. He chooses that investment in which he expects to make the highest possible profits.³

Mises then adds,

Nobody embarks upon any investment if he does not expect to make a good investment. Nobody deliberately chooses a malinvestment. It is only the emergence of conditions not properly anticipated by the investor that turns an investment into a malinvestment.⁴

Furthermore, in an attempt to minimise risk, practitioners of MPT tend to institute a high degree of diversification. However, having a large number of stocks in a portfolio might leave little time to analyse the stocks and understand their fundamentals. This could raise the likelihood of putting too much money in bad investments. This way of conducting business would not be an entrepreneurial investment but rather gambling.

One of the world's most successful stock market investors, Warren Buffett, argues that an investor's financial success is in direct proportion to the degree to which he understands his or her investment. This understanding, according to Buffett, is what separates investors with a business consideration from gamblers who merely buy stocks. Buffett says that investors are better served if they concentrate on locating a few spectacular investments rather than jumping from one mediocre idea to another⁵.

John Maynard Keynes expressed a similar view:

As time goes on, I become more convinced that the right method of investments is to put fairly large sums into enterprises which one thinks one knows something about and in management of which one thoroughly believes. It is a mistake to think that one limits one's risk by spreading too much between enterprises about which one knows little⁶.

³ Ludwig von Mises (1963) Human Action, Chicago IL. P 810

⁴ Ibid

⁵ Hagstrom, R.G. Jr. (1995), The Warren Buffett Way, New York.

⁶ Ibid, p 68.

GLOSSARY

Money AMS - stands for the Austrian School of Economics money supply definition. The aim of this definition is to ascertain as accurately as possible the amount of money in an economy.

Monetary liquidity - stands for the yearly rate of growth of money AMS adjusted for the rate of growth of nominal economic activity.

The pool of funding - stands for the stock of final goods ready for human consumption. The state of the pool sets the limit for economic growth.

Real savings – the amount of consumer goods produced locally less the amount taken by the producers of these goods.

The reshuffling process - the diversion of real savings from wealth generating activities towards activities that sprang up on the back of loose monetary policy.

Productive consumption - consumption that is preceded by production of wealth i.e. consumption that is backed up by the production of wealth.

Non-productive consumption - consumption that arises as a result of monetary pumping and is not supported by wealth production. This type of consumption weakens the flow of real savings.

Unbacked loans - lending that is not backed up by real savings. This type of lending is created through fractional reserve banking i.e. lending out of "thin air".