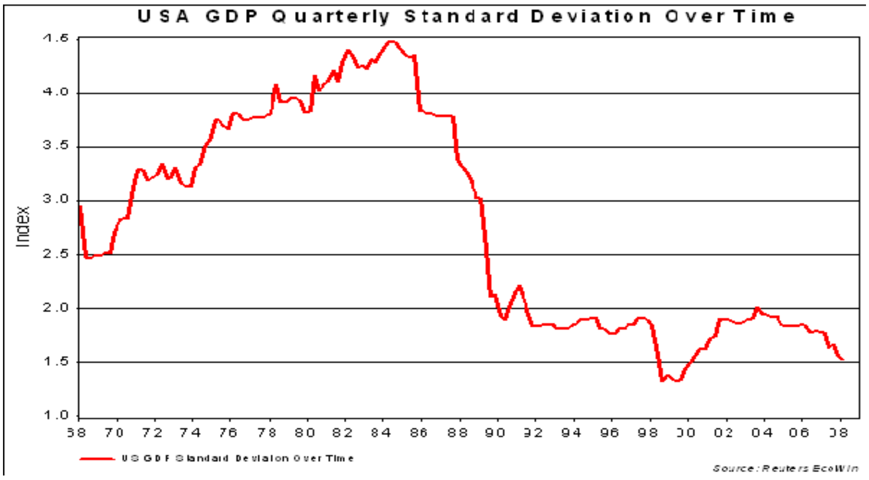
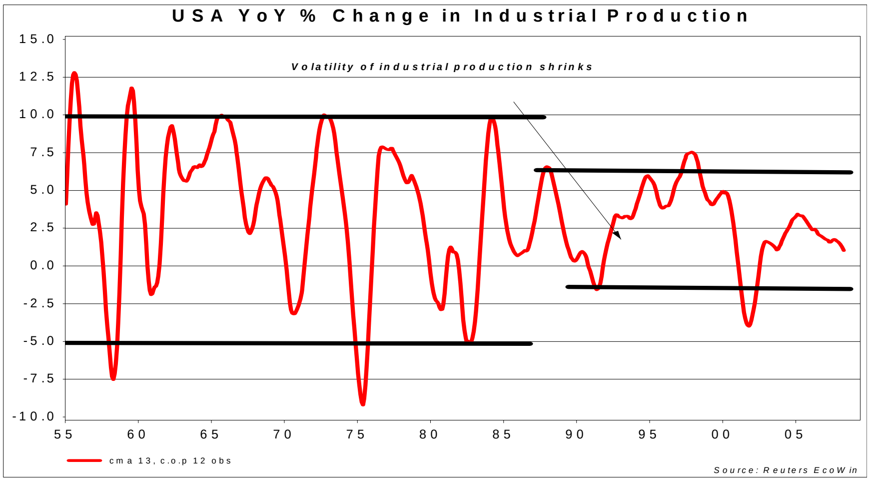
The "Efficiency Capital" Bear Market

Louis-Vincent Gave
CEO
GaveKal

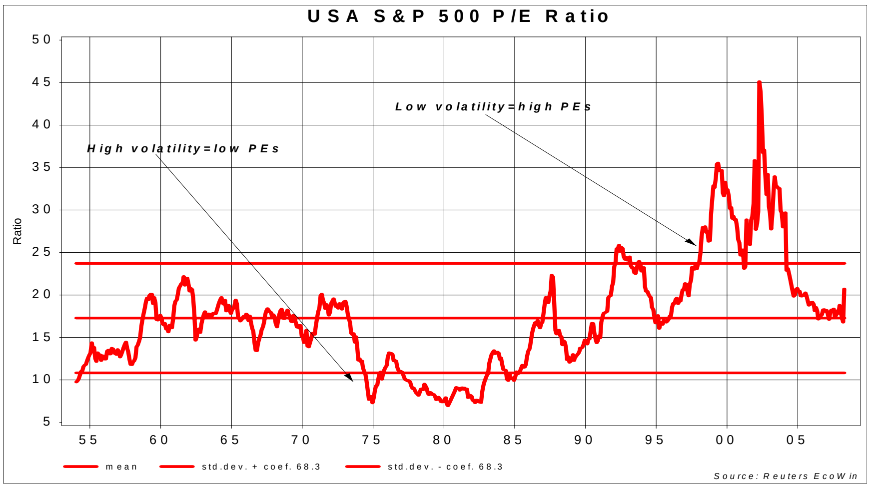
The Collapse in the Volatility of Growth



Lower Growth Troughs



Lower Volatility = Higher PEs



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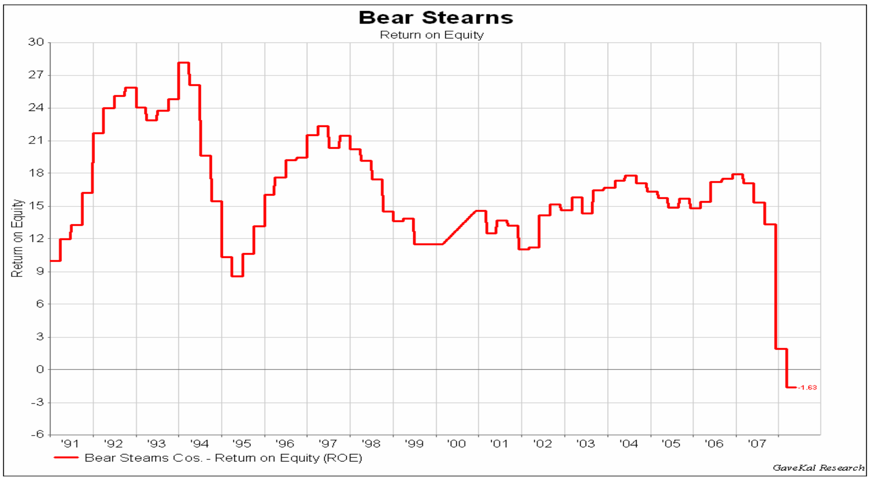
Bear Stearns Return on Equity



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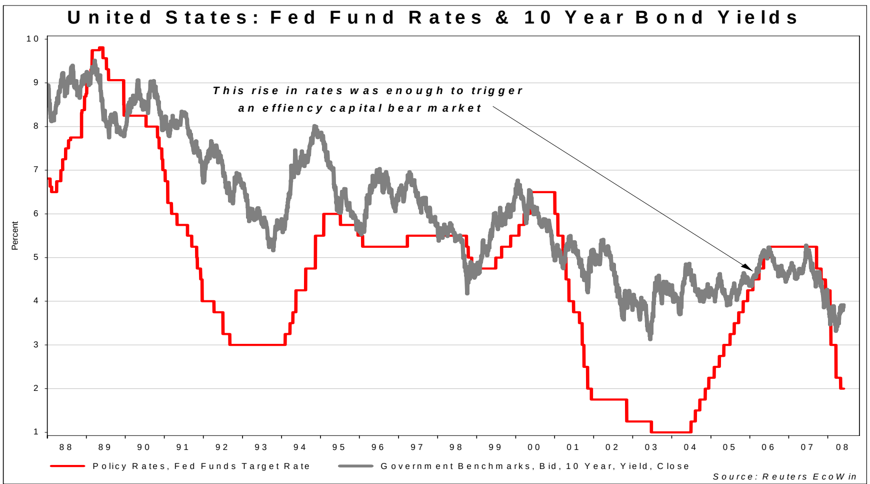
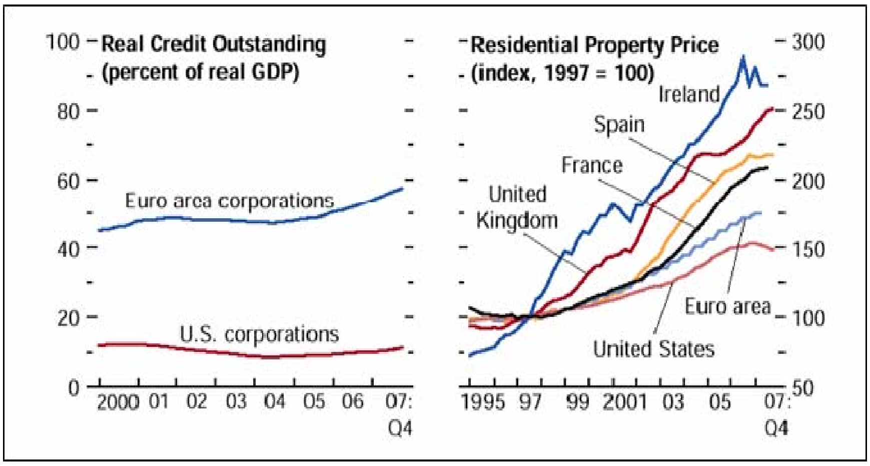
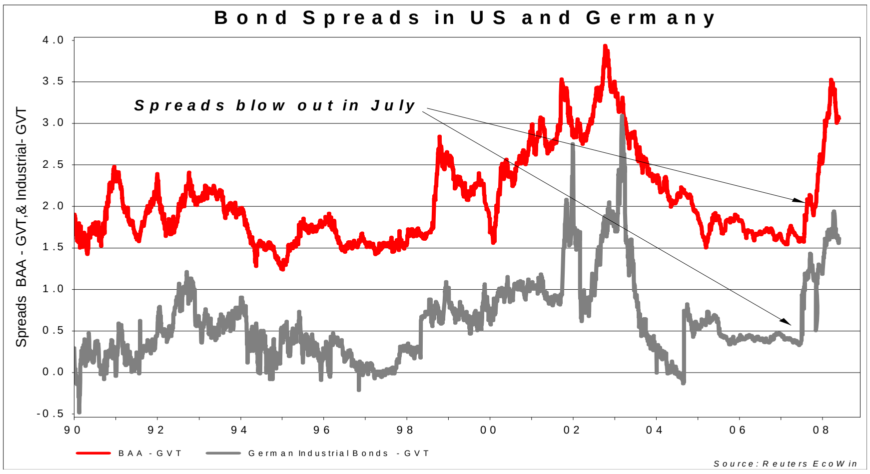
The Smallest of Rate Increases Triggered a Bust



Credit Did Not Go into Companies but into Real Estate



The Price of Money Shoots Up



Differentiating Between Bubbles

- Over the years, we have had the chance to witness several bubbles come and go. And, while it is obvious that two bubbles are never the same, it seems that bubbles often show similar patterns. In fact, we find two different kinds of bubbles:

1. The first kind of bubble takes place on non-productive assets (typically land & real estate, but also tulips or gold…).
2. The second kind of bubble takes place on productive assets (e.g., canals, railroads, telecom lines).

- In the first kind of bubble, prices are bid higher due to a 'rarity' factor. In the second kind of bubble, prices rise because investors misjudge the future returns on the assets. When the bubbles burst, in the first case, we are left with no more land (or gold, or oil…) then what we started with. In the second case, productive capital has been put in place which can still be exploited, either by its current owners, or by a new set of owners.
- An example of the first kind of bubble would be the tulip-mania of 18th Century Holland. An example of the second is the US and UK railway bubble of the 19th Century, or the tech and telecom bubbles of the late 1990s. In Holland, when the tulip bubble burst, people were left with their eyes to cry with. In the US and the UK, when the railway bubble burst, the domestic economies still had trains to ride. All around the world, when the telecom bubble burst, consumers were left with the ability to make cheaper calls and transfer data more cheaply. In turn, this led to much higher levels of productivity (i.e., the birth of Indian and Filipino call centers), growth and a higher standard of living.

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The Second & Third Differences

- Another very important difference between bubbles is in the way that they are financed:

1. If the bubble is financed by banks, when the bubble bursts, the banks' capital disappears, and the velocity of money collapses (for more on velocity, see *Our Brave New World*).
2. If the bubble is financed by capital markets (corporate bonds, junk bonds, and equities…), those owning the overvalued assets take a beating. If they hold those assets on leverage, then the assets get transferred to more financially-sound owners. Otherwise, the buck stops with the overpriced assets' owners. So the worst possible bubble (i.e., the most recessionary) is a bubble in unproductive assets (gold, land, tulips…) financed by banks. The best possible kind of bubble (i.e., one that does not hurt growth too badly) is a bubble in productive assets, financed by capital markets.

- The Japanese bubble of the late 1980's was a 'bad' bubble. It was mostly in real estate and was financed by Japanese banks. By contrast, the bubble of the late 1990's was a 'good' bubble. It was mostly in technology (too much telecom and computing expansion) and was financed by capital markets (junk bonds and equities).
- Then there is a third and final differentiating factor between bubbles, namely the policy response and the ability of companies to go bankrupt. Indeed, in order for deflation to end, **productive assets have to move from weak hands to strong hands.**

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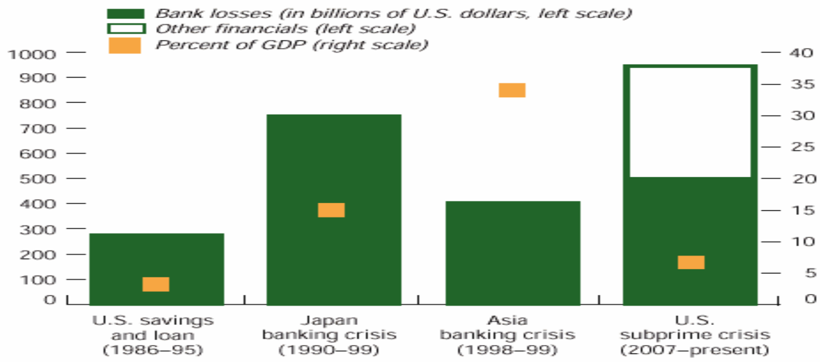
A Serious Financial Crisis

Figure 1.12. Comparison of Financial Crises



Sources: World Bank; and IMF staff estimates.
Note: U.S. subprime costs represent staff estimates of losses on banks and other financial institutions from Table 1.1. All costs are in real 2007 dollars. Asia includes Indonesia, Korea, the Philippines, and Thailand.

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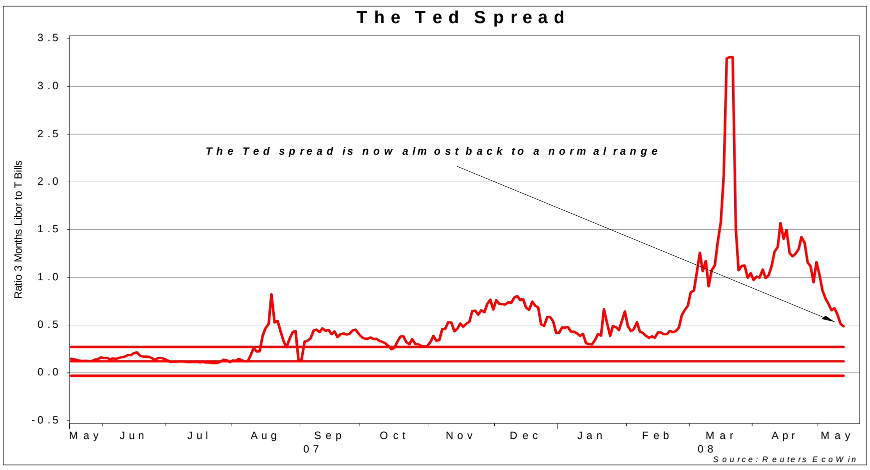
The Ted Spread Comes Back Down



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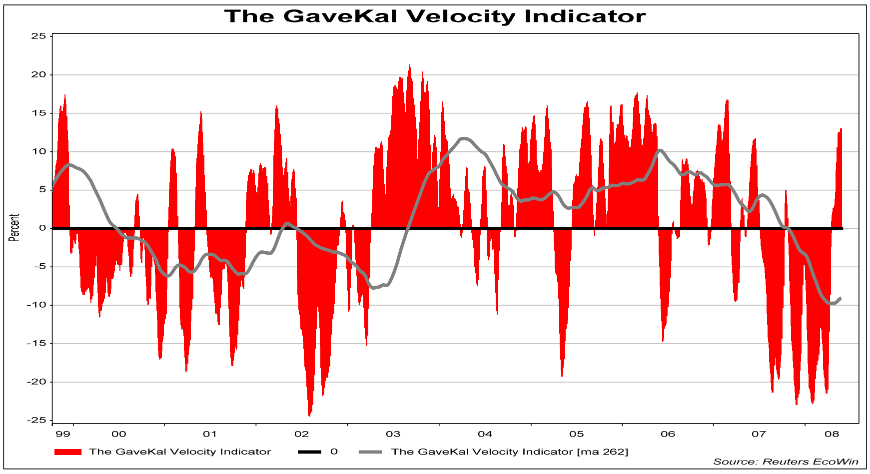
Velocity of Money Ticks Higher Again



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Getting Out of the Mess: The Three-Step Process

- In recent years, we have experienced a fair share of banking crises: the Savings & Loan crisis in the US in 1990; the Scandinavian bank meltdown in 1992; the Credit Lyonnais blow up in 1994, Thailand and South Korea at the onset of the Asian crisis in 1997; and, all the while, Japan has struggled with its crisis for the last 15 years. In hindsight, we note that the remedies for all of these financial crises seem to be the same, namely:

1. **A Currency Collapse:** This supports exports and, more importantly, helps to attract foreign capital.
2. **An Easing of Monetary Policy and a Steep Yield Curve:** For markets to clear in the aftermath of a crisis, they need liquidity.
3. **A Recapitalization of Balance Sheets:** Even if rates are low, if the banks' balance sheets are destroyed, the banks will sit on their hands. We have learned this much from fifteen years of studying Japan.

- In the past, it has taken at least two to three years for all of these developments to materialize. However, in the US today, the three-step program seems to be happening in a matter of months: 1) The US$ has already collapsed, and 2) The Fed has cut very aggressively in a short period of time.

- The main question, however, is 3) Have the banks' balance sheets been recapitalized enough to ensure that the rot stops spreading? Or are we facing a genuine market failure?

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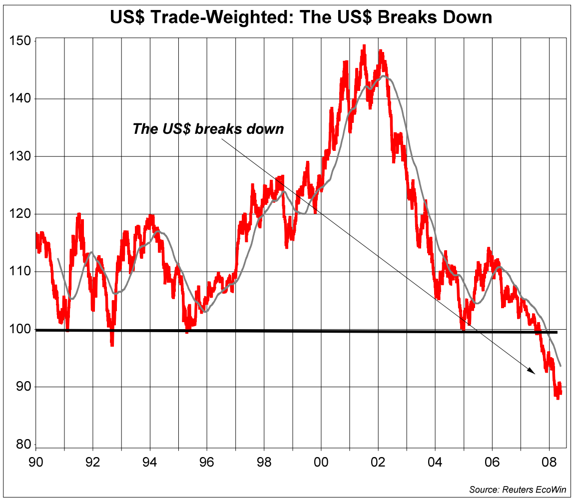
Step 1: Collapsing the Currency



- The collapse of the US$ has already happened.
- Or at least, it has happened against the world's "commodity currencies" and the world's "savings currencies".

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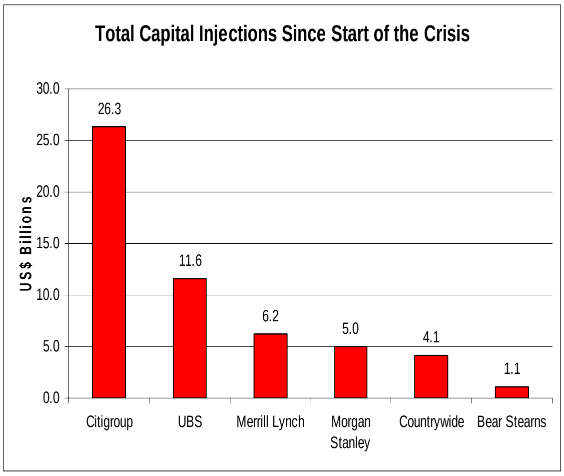
Step 2: Recapitalizing the Banks – But Has Enough Been Done?



- One of the amazing features of this crisis is how quickly the US banks put up their hands and admit their troubles.
- The crunch started to really hurt in August, and by December, a lot of institutions had gone to the market for more capital.
- Unfortunately, this was not sufficient to prevent the rot from spreading.

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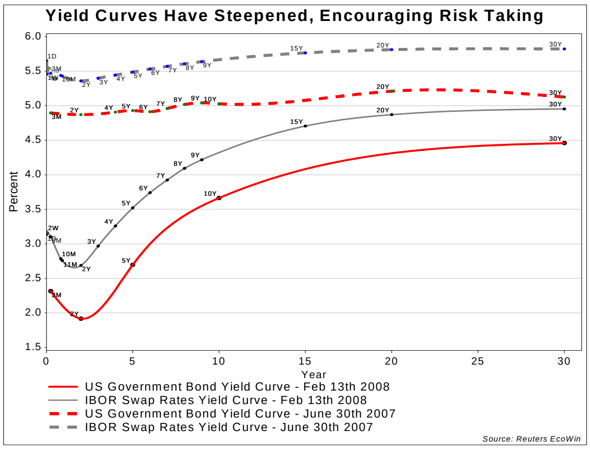
Step 3: Cutting Short Rates & Steepening the Yield Curve



- In December, the Fed was clearly "behind the curve".
- Having now slashed short rates, the yield curve is nice and steep between 2 years and 15 years. This encourages risk-taking.

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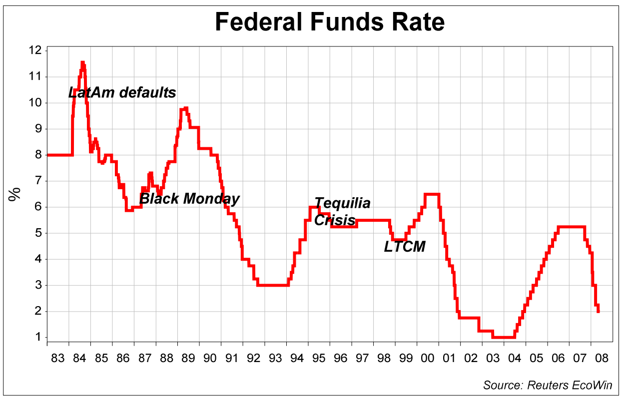
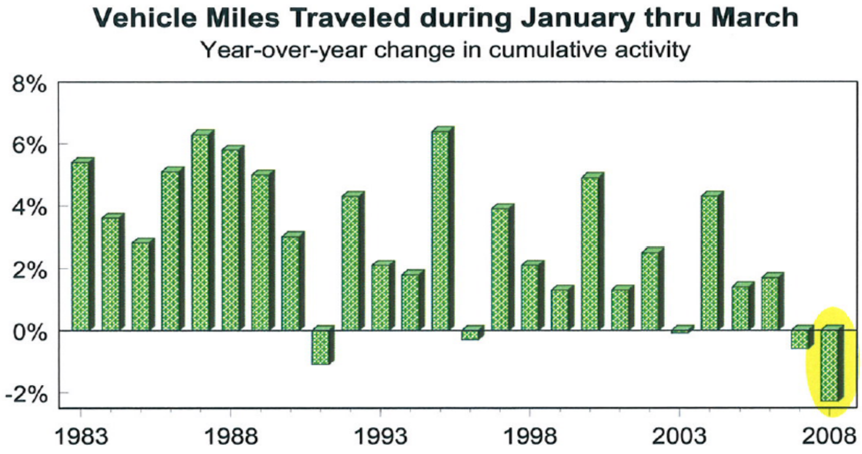
The Fed Has Been Cutting Aggressively

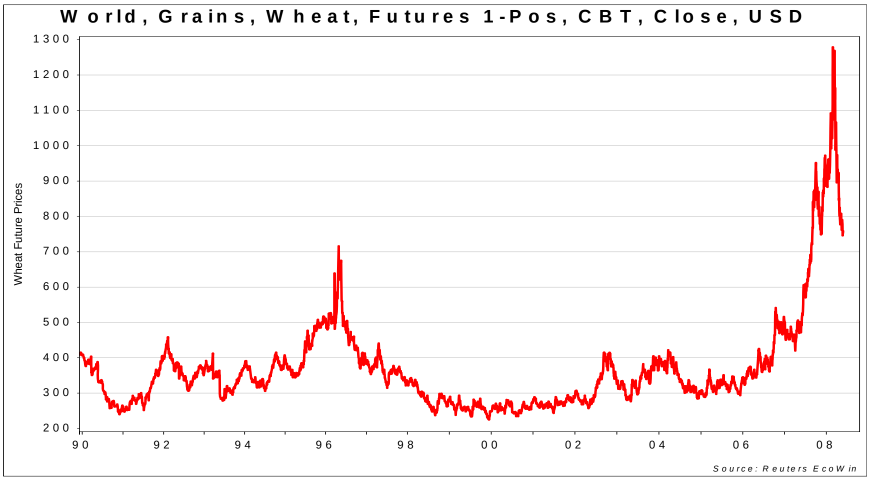


- In previous credit crunches (1987 Crash, Tequila Crisis, LTCM crash…) the Fed cut rates an average of 75bps.
- This time around, the Fed has already cut rates by 225bps.
- Obviously, this is no ordinary credit crunch… But the Fed seems to be willing to collapse the cost of capital to help out.

Commodity Demand Wanes, Prices Soar?



The Parabolic Rise in Commodities



For more information on this presentation or our research, please contact:
sales@gavekal.com
Tel: 852 – 2869 8363

Or go to our website for more details:
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