

## Variant Perception – May 2010

### PIIGS Get Slaughtered; Asia Drowns in Liquidity

**The European periphery highlights the dwindling belief in sovereign guarantees and the return of the bond vigilantes. The periphery will struggle in a debt deflationary spiral, while Asia will continue to be overwhelmed by loose liquidity from the developed world. We anticipate bubbles in Asia, and particularly India, given its easy money policies and negative real interest rates.**

#### **THEMES**

- > **Greece will eventually default and the periphery will remain under pressure** – While the EU and the IMF may help in the short run, Greece will likely seek debt restructuring and avoid technical default, but the result is the same. We continue to prefer spread widening in the periphery and CDS trades rather than being short the Euro. The European periphery has all the hallmarks of Asia in 1997 besides a foreign exchange asset/liability mismatch. All periphery countries are very reliant on foreign funding. We believe the European periphery will experience painful deflation and sovereign and private defaults. The crisis in Eastern and Southern Europe is ahead of us, not behind.
- > **Government bonds are the only obvious existing bubble** – We have highlighted many countries that are ripe for asset bubbles. However, the one asset class that is truly in the final stages of a multi-decade bubble is government bonds. Currently government bonds are universally hated, so tactically we would not short them, but structurally, we see very little way most governments will be able to reduce the size of their debts given profligate promises and little political will to reduce spending. We view inflation or default as most likely outcomes.
- > **Sovereign debt to GDP ratios of developed nations will prove exceedingly difficult to reduce** – Countries can try to reduce their debt burdens by stimulating growth or stoking inflation. The most effective way, though, is to reduce the cyclically-adjusted primary deficit. However, this involves unpopular cost cutting measures and tax rises. If governments choose this route, this will act as further structural resistance on global growth.
- > **The upcoming UK election will likely be positive for sterling volatility** – The outcome of the UK election on the 6<sup>th</sup> of May is very uncertain. There are several possibilities and the degree of uncertainty, we believe, will persist in the weeks or months after the election. With the UK's enormous fiscal problems, we believe this will prove positive for sterling volatility.

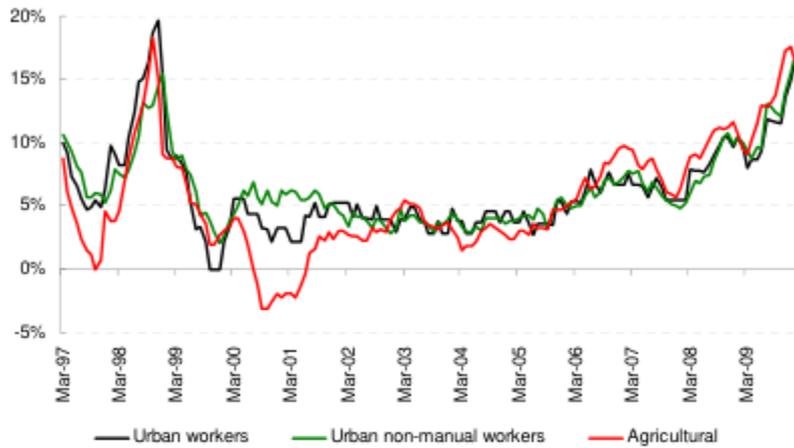
- > **Potential for black swan “Credit Anstalt” type event** - It is not our base case that we have another financial crash so soon, but we are vigilant to any extreme contagion events in the European periphery. We have flagged before that sovereign defaults typically follow banking crises by two or three years. The main event that led to banking failures in the Great Depression was not the 1929 crash but the 1931 financial crisis that began in Austria because of Credit Anstalt.
- > **Inflation is being underpriced globally, but central banks will not respond the same way** – India already has 11% inflation, and within nine months, we think Chinese inflation will surprise very strongly to the upside and reach 8-10%. Other emerging markets will also experience rapidly rising inflation. We favour EM yield curve flatteners and being short the front end of EM yield curves. We believe India will become a large importer of agriculture going forward, exerting the same effects on grains and softs that China has exerted on base metals.
- > **Real interest rates already negative in many emerging markets** – Rising CPI and accommodative central banks is causing real interest rates to be negative. Negative real interest rates fuel excess lending, which is the clearest precursor to financial bubbles. Investors are focused on a Chinese bubble, while we believe India will experience the extremely expansionary lagged consequence of negative real rates. We recommend Asian flatteners.
- > **Asian currency appreciation key to determining when the party will end** – As long as Asian countries keep their currencies from appreciating, the massive reserve accumulation will continue and will lead to expansive domestic monetary policies. We anticipate continued Asian currency appreciation. Substantial Asian currency appreciation would represent significant global liquidity tightening. We recommend being long a basket of Asian currencies.
- > **Lower trend growth and greater macroeconomic volatility ahead are important structural breaks from the past** – We have seen a secular decline over the last four cycles in trend growth across GDP. We also anticipate greater volatility in the business cycle going forward. The net effect is growth in the US will dip more frequently below zero and recessions will be more frequent. We believe this has very important implications for equity and bond investors across asset classes.
- > **There is more than one unemployment rate in the US** – We believe the disparity in unemployment levels between high education and lower educational levels is part of a profound structural change in the labour market. As employment and wages stagnate at the lower end, any reflationary monetary policy will reduce real incomes of the poor. Consumer staples and high end discretionary spending will remain robust.
- > **Sovereign risk underlines the need to hedge currency debasement** – Countries that can “print” their currencies will, and we believe questions of sovereign solvency and inflation highlight the need to own gold as a hedge. Gold has recently formed an inverted head and shoulders pattern, and fears about government solvency in the European periphery underline the fear of sovereign crises spreading.

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### ASIAN LIQUIDITY ABUNDANT; INFLATION AHEAD

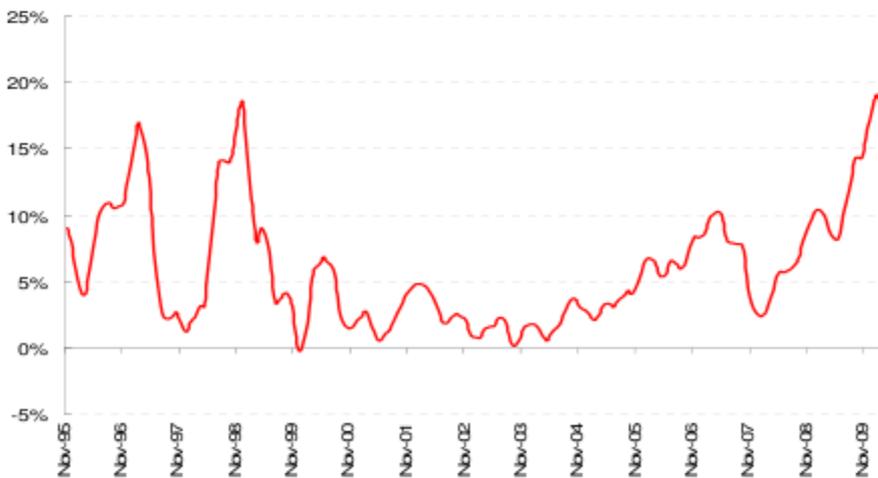
Inflation in many Asian economies is rising quickly. Fiscal and monetary stimuli will soon be exerting their full effects and this will put further upward pressure on prices.

India CPI

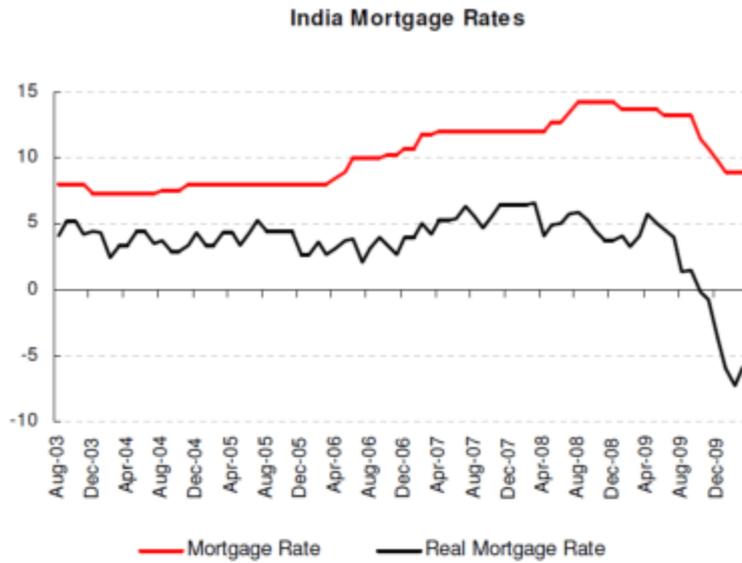


Inflation rates in India are about 14% across most measures and food inflation is running at about 20%. We would note that the inflation is not solely restricted to food, and we believe inflation will remain higher than the Reserve Bank of India would like.

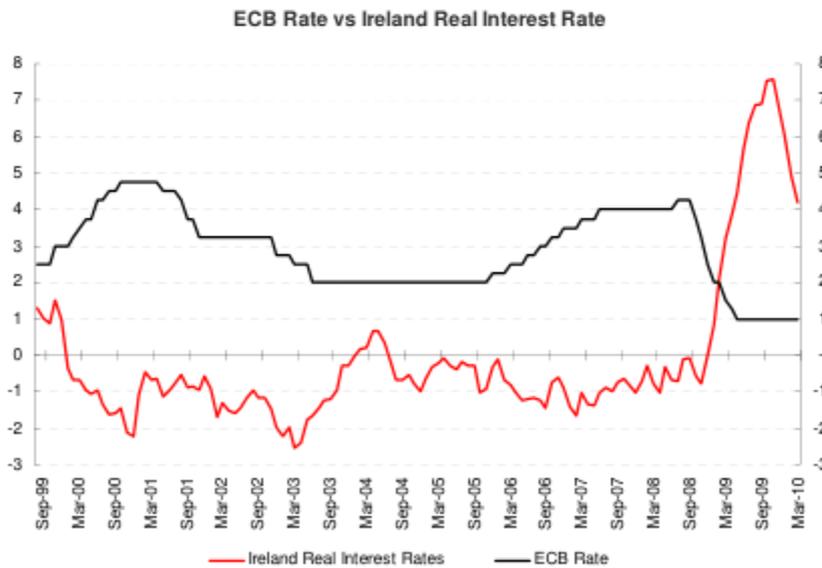
India Food Inflation, YoY  
(3m average)



The result of high inflation and loose monetary policy is that real mortgage rates in India are now deeply negative. In fact, India has the highest inflation rate and the most accommodative monetary policy in the world currently.



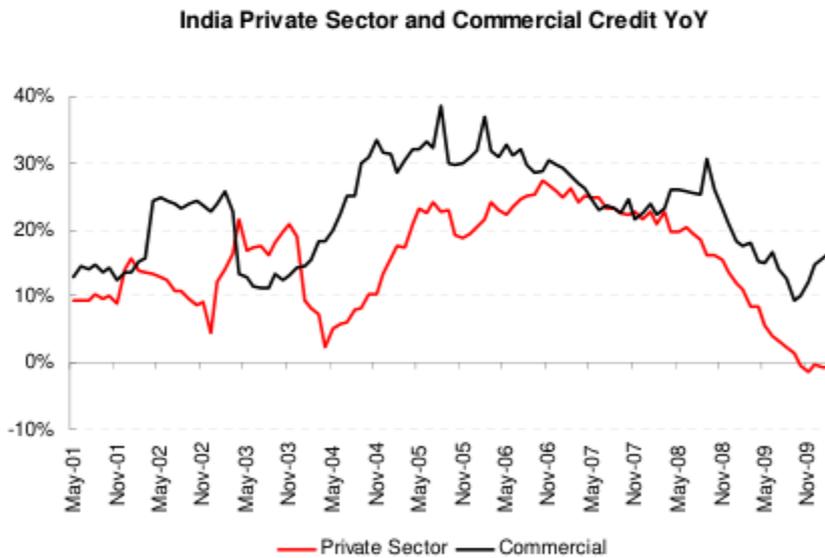
We have written before that one of the most certain precursors to financial bubbles are negative real interest rates. The following chart shows what negative real interest rates did in Ireland. Effectively customers were being "paid" to borrow money as inflation outstripped interest and mortgage rates.



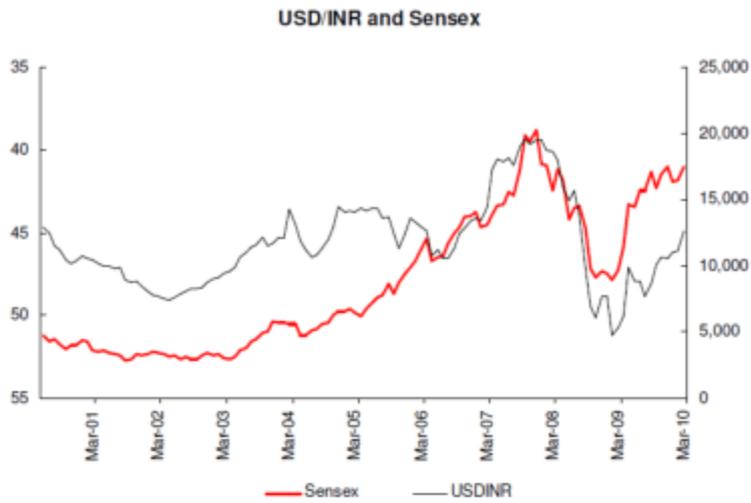
The very accommodative stance of the RBI is particularly odd given very high inflation and surging industrial production. Indeed, the three month moving average of industrial production never went negative during the Great Recession. India was one of the few global exceptions to the downturn. Now growth is surging at a higher pace than at any point in the last decade. We believe the RBI is being very complacent.



As the following chart shows, despite the global downturn, credit growth never turned negative in India. Indeed, commercial credit has turned positive once again.

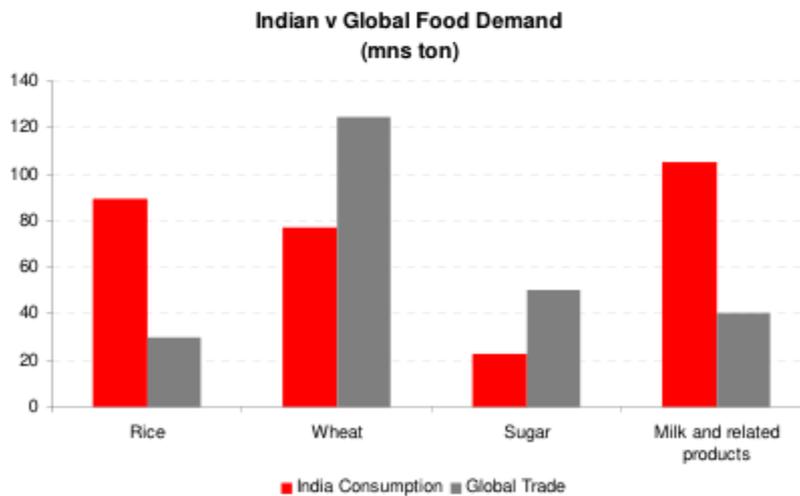


The Indian Rupee has appreciated recently, and the prospect of further appreciation will only fuel increases in the Indian Sensex stock index.



Our base case is that absent aggressive hiking by the RBI (and the recent 25bps hike rather than the expected 50bps supports this), India is a prime candidate for a large property and stock market bubble as negative real rates drive credit growth and mortgage lending. This has happened in almost all countries that have had negative real rates.

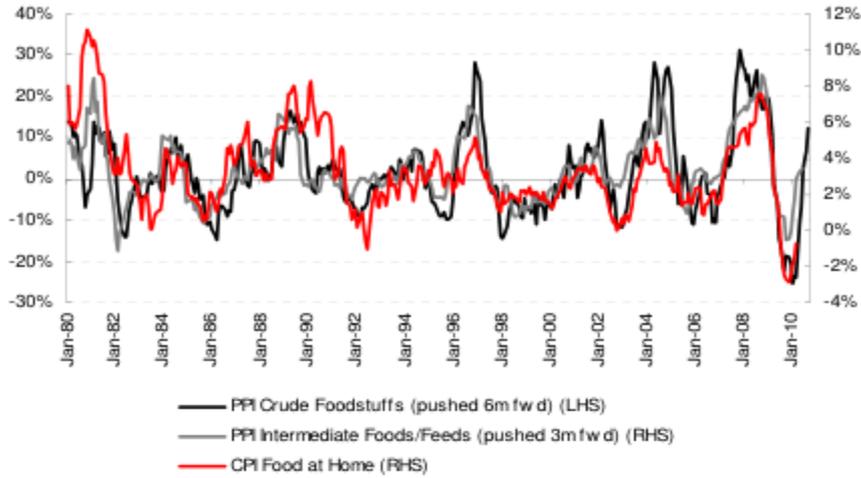
**We believe India will become bigger buyer internationally of foodstuffs. India will do for agriculture, what China has done for copper, iron ore, coal, and most rare metals.** As the following chart shows, India's growing food needs in some agricultural commodities dwarf global trade in food.



Source: Credit Suisse

Even in the United States, our own forecasts are for higher food prices ahead. One of our key themes for 2010 is higher food inflation, and we believe that we will soon start to see a rise in food prices based on the correlation of crude and intermediate foodstuffs in PPI.

US PPI Points to Rise in Food Prices

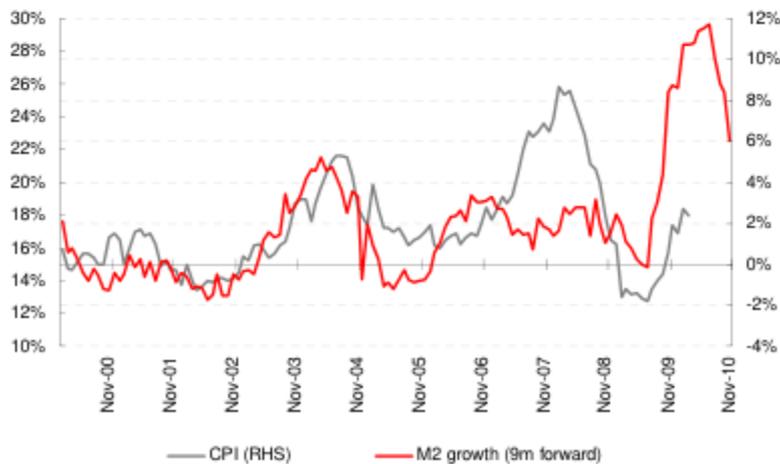


We believe markets are being very complacent about the potential for increases in food prices and pass through inflation outside of headline inflation.

### CHINA AND HONG KONG UPDATE

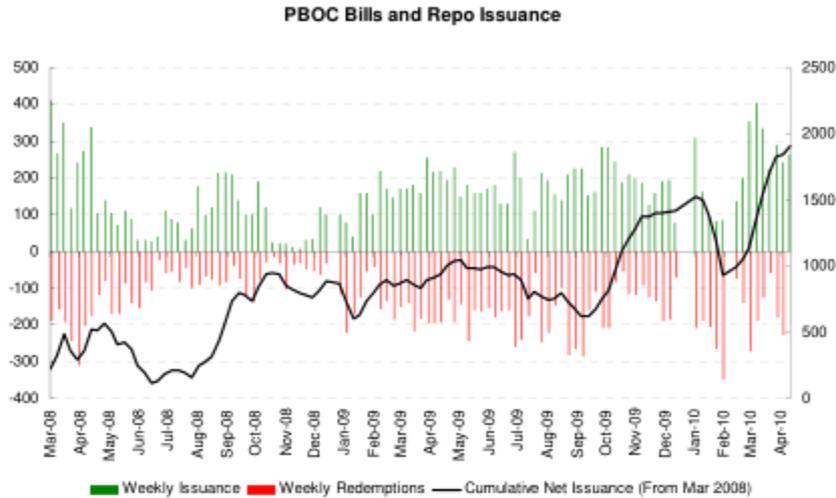
We wrote earlier this year that we anticipated higher inflation in China based on the lagged effects of extremely accommodative monetary policy and the surge in lending. We are beginning to see an strong increase in inflation in China. We anticipate that inflation will rise throughout the rest of the year.

China M2 growth and CPI

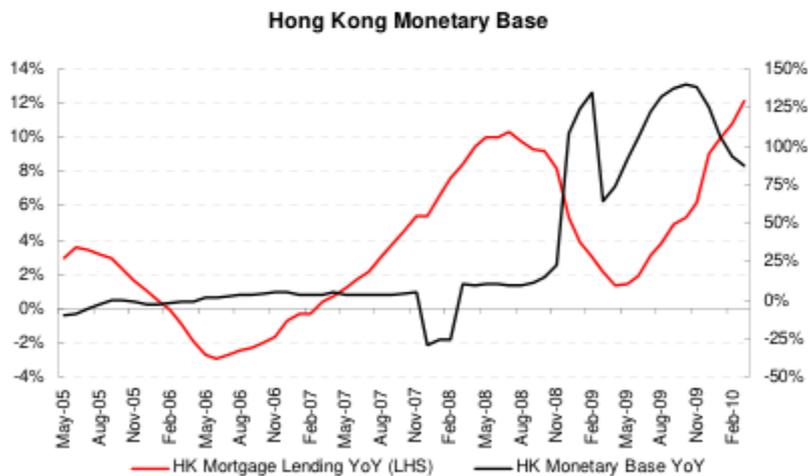


As inflation rises, policymakers of most Asian countries will move to try and contain it. Rising prices, especially food prices, are a huge problem in many developing countries. Pakistan, where CPI is over 12% YoY, has recently faced a spate of strikes and riots triggered by an almost 20% rise in food prices over the last year.

Mindful of such risks, Chinese authorities have begun to sterilize their money supply. The chart below shows the steady increase of net issuance of bills and repos, helping to soak up some of the excess liquidity.

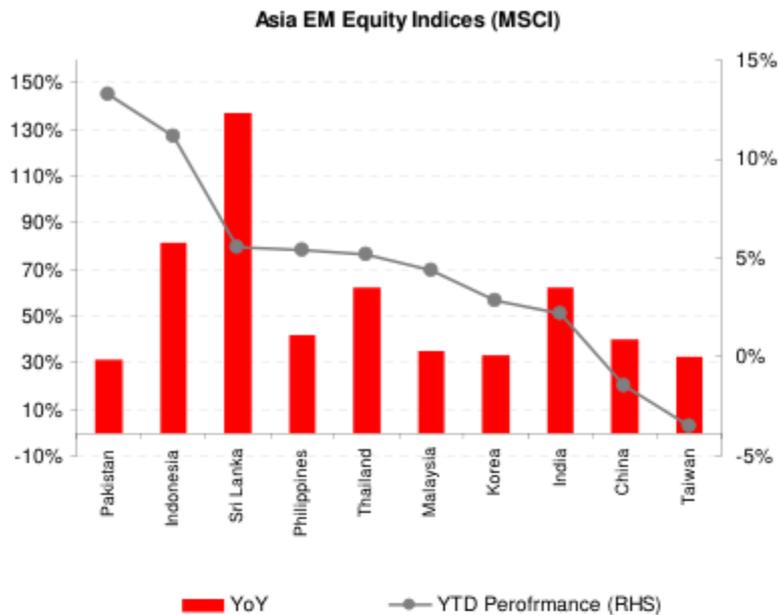


Hong Kong's monetary base continues its rapid expansion, driven by the dollar peg and the US's maintenance of very loose monetary policy. On a YoY basis, it is still rising at almost 90%. Mortgage lending, too, is now expanding at a rapid pace, over 125% YoY. We believe Hong Kong's housing market is in bubble territory.



## GLOBAL EXCESS LIQUIDITY AND ASIAN STOCK MARKET VALUATIONS

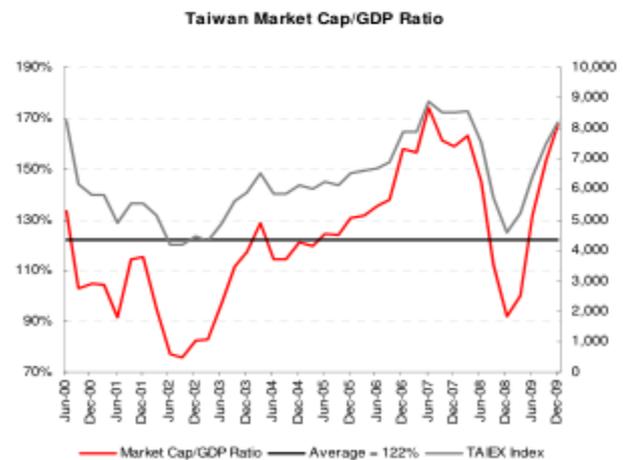
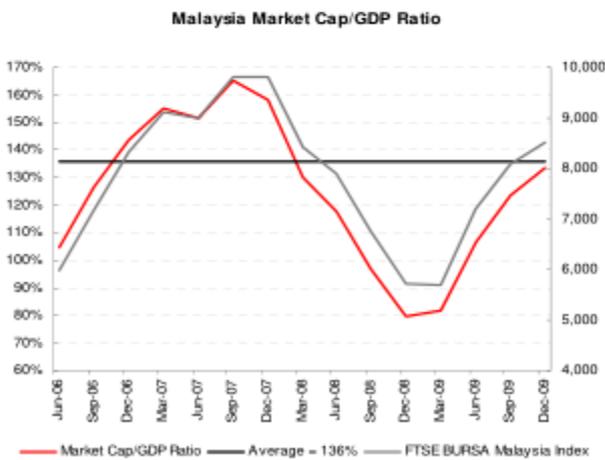
We believe that many Asian stock markets will continue to outperform on the back of excess global liquidity. However, many have already enjoyed very robust rallies. While this does not preclude them running further (we reiterate what we have said on several occasions, i.e. that excess liquidity is a very powerful force and can drive prices far, far beyond any notion of 'fair' value), it is worthwhile taking a closer look to see a more nuanced picture.



One measure to help get an idea of where valuations are is to look at the size of the stock market in relation to the size of the overall market, i.e. the market cap / GDP ratio. Warren Buffet has referred to this measure in the US as “probably the best single measure of where valuations stand at any given moment”.

A rule of thumb is that when the market cap / GDP ratio is in the range 75%-90% the market is fairly valued; from 90% up to 115% it is modestly overvalued; and at over 115% it is very overvalued.

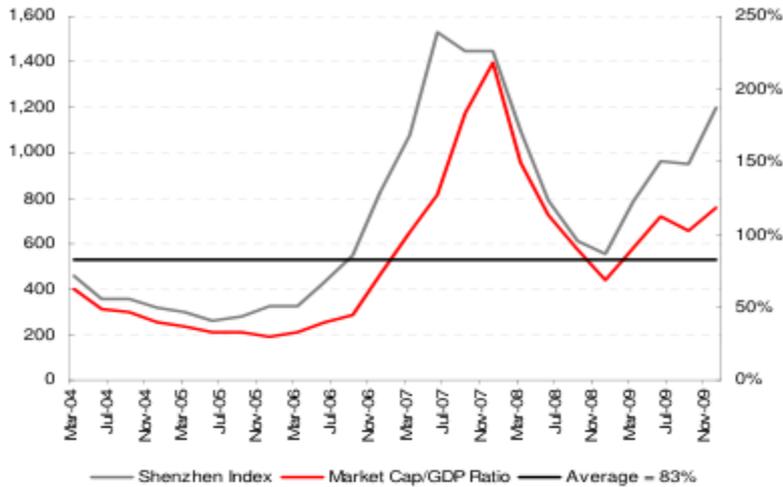
On this basis, two markets in Asia-ex Japan stand out as being in very overvalued territory: Taiwan and Malaysia.



Malaysia's ratio is approaching 140%, near its average (although we only have data back to 2006 so this is a very short average). In Taiwan the ratio is straight through its 10 year average and heading to 170%. Taiwan has by far the highest market cap / GDP ratio in emerging Asia and looks significantly overvalued.

And also in very overvalued territory, by a smidgen but rising fast, is China with a market cap / GDP ratio of 118%. However, China is way below the peak this ratio reached of over 200% in 2007.

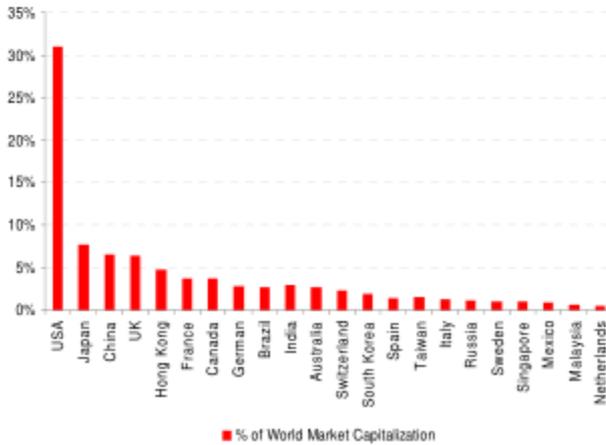
China Market Cap/GDP Ratio



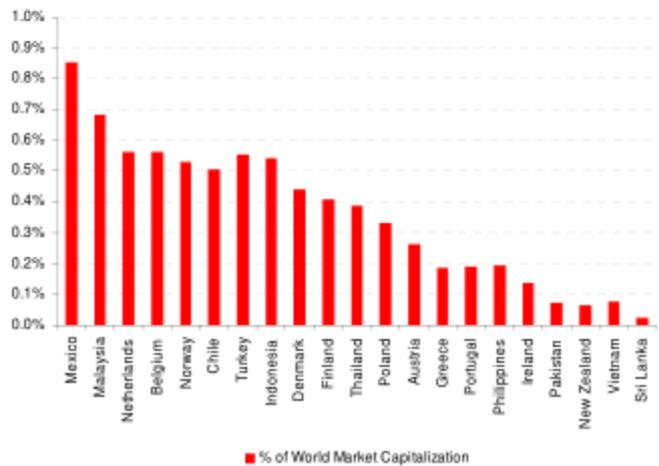
Nevertheless, although some short-term caution may be warranted in these markets, we remind our readers of the powerful combination huge excess global liquidity, strong fundamental stories, and market sizes that are still very small relative to those of developed countries.

The two charts below give some idea of how the US dominates world equity market capitalizations, and how miniscule emerging markets are in comparison.

World Stock Markets % of World Mkt Cap



World Stock Markets % of World Mkt Cap



To further highlight the point, we compared the size of some EM equity markets to several US blue-chip companies. For instance, Microsoft's market cap is about 80% of the Malaysia stock market's total market cap, and it is bigger than Indonesia's market cap. The Philippines' market cap is smaller than that of Apple, GE, Google and Wells Fargo. Vietnam's market cap is smaller than that of Research in Motion's.



Regardless of any measures of valuation – which may or may not prove to be prescient – small emerging markets could be overwhelmed by excess liquidity emanating mainly from Europe, the US and Japan. As ongoing problems with Greece signal, it is unlikely monetary policy – certainly in Europe, but also likely the US and Japan as well – will be tightened significantly in the near future.

We have previously used the simile “like a fire hose through a straw” to describe the effects of loose developed market monetary policy on emerging countries with small asset markets. We think this remains a most apt description for the outlook today.

### UPDATE ON THE US: MOMENTUM HAS PEAKED

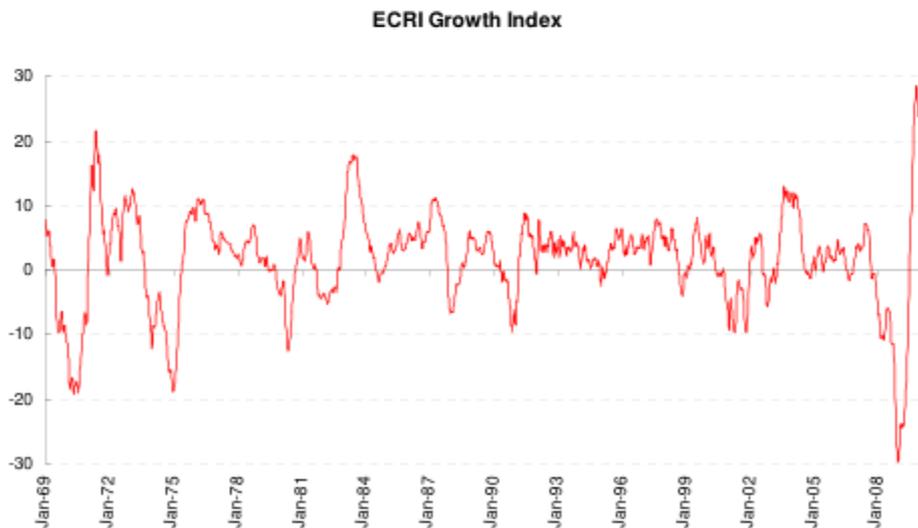
In the US we do not forecast a double dip downturn in the next 12 months. Our base case is for robust growth. Indeed, the Leading Economic Indicators are at multi-decade highs. We view the chances of a double dip recession in the next twelve months as being close to zero.



However, we would caution that various measures which do a very good job of forecasting the Leading Economic Indicators have now started to roll over. Growth will be positive, but momentum has peaked.



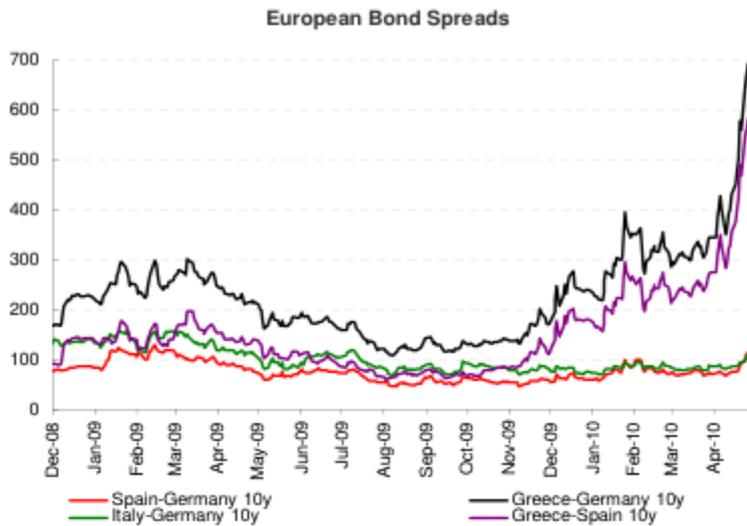
ECRI's leading index, which moves faster than the Leading Economic Index of the Conference Board, has turned over decisively, showing that growth will still be strongly positive, but momentum has peaked.



**EURO PERIPHERY: GREEK DEFAULT CERTAIN, SPANISH ROLLOVER RISK SUBSTANTIAL**

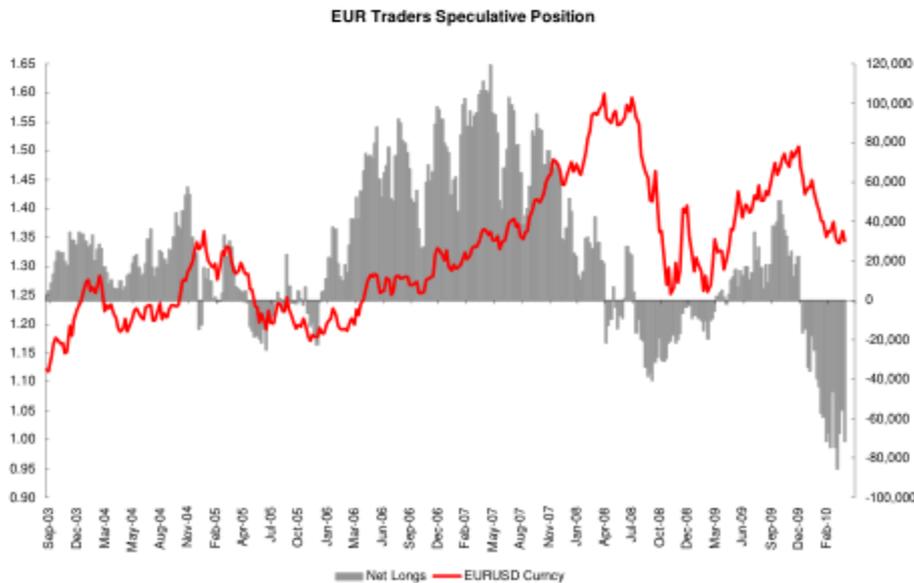
Every day brings new headlines of a potential rescue of Greece. We believe any rescue faces many obstacles and will ultimately fail in its aims. National governments could scupper any deal, particularly in Germany, where there is little political will to bail out Greece, and even if Greece were to comply with draconian cuts, a debt deflationary spiral would only make further bailouts necessary.

Our base case is that Greece will ultimately experience a practical, as opposed to technical, default. Most likely we will see a voluntary restructuring of Greek debt involving a substantial haircut that will simply formalize what is already happening in the financial markets. It is a matter of *when*, not *if*. The ECB will do what it can, as the recent suspension of the application of a minimum credit rating threshold to collateral eligibility shows. Once the bond vigilantes have moved on from Greece, the rest of the periphery will be in their sites. This is the way every international crisis evolves, whether it be Asia in 1997 or the banking crisis of 2008.



Greece has a government debt to GDP level of 120%, Portugal of 90% and Spain 54%. It is worth remembering that Argentina's debt to GDP ratio was 64% in 2001, one year before default. Most countries in the world are now running above the debt level at which Argentina defaulted, but European periphery countries look most like Argentina with large debts in a currency they cannot print.

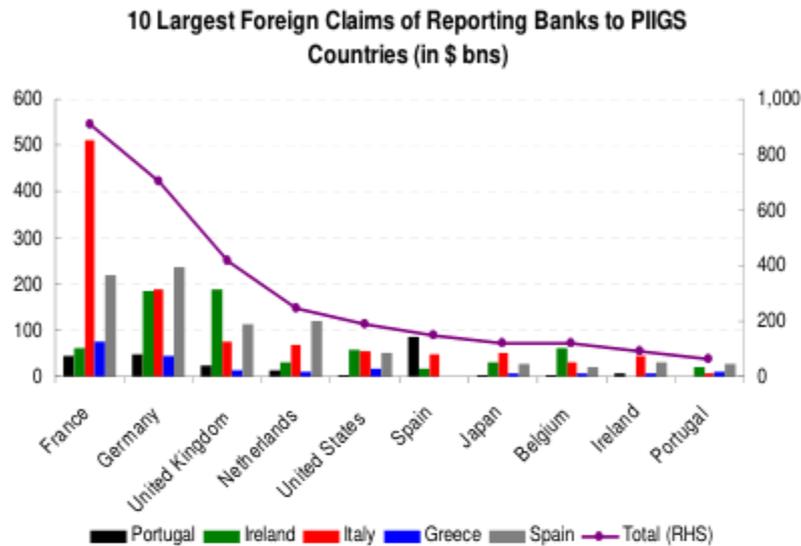
We continue to prefer Spain and Portugal spread wideners rather than EURUSD shorts. We recommend initiating or adding to positions on any short covering rallies. We have yet to speak to a client who likes the euro, while in November we couldn't find anyone who liked the dollar and that proved to be the low in the dollar. As the following chart shows, we are near historic extremes in positioning and sentiment of the Commitment of Traders (COT), and we doubt there is a single currency trader out there who is unaware of the problems in Greece.



Paradoxically, we believe any default will be good for the Euro in the long run. The Euro can be a "hard" currency like the Deutschmark or a "soft" currency like the Drachma. A debt restructuring would fall into the hard category; while a profligate rescue would raise the stakes in the moral

hazard game and would make the Euro more like the drachma. We will ultimately take our cue from national governments and the ECB.

The real danger to the Euro area is large scale contagion to European banks holding the bag of defaulted Greek paper and distressed Spanish and Portuguese debt.



Source: BIS

We think Spain is the greater problem than Greece, while Portugal's economy is even smaller and less significant than Greece's. As we have written before, Greece is less than 2% of Euro area GDP, while Spain is almost 12%. In relative terms, Greece defaulting would be like Arkansas or Mississippi defaulting for the US. In absolute terms, Greece's economy is about the size of Massachusetts, while Spain's economy is almost the size of California.

Our base case is not a Spanish default, but we believe investors are not being adequately compensated for rollover risk in Spain or the cost of upcoming banking bailouts that we expect in Spain. Spain's leverage problem is concentrated in its household and corporate sector, and we have yet to see any meaningful deleveraging. Indeed loan growth to the construction sector, astonishingly, has not even declined, proving that a rolling loan gathers no loss.

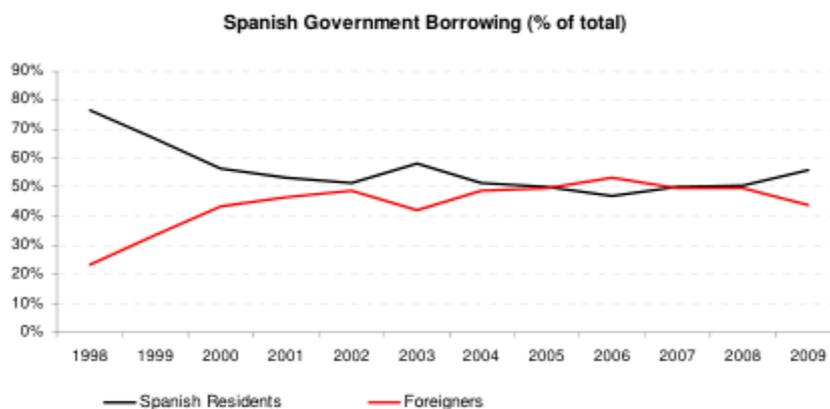
One of the reasons why Greece has been pushed into the limelight now is it had large upcoming debt refinancing (and new issuance) to deal with. Spain is not substantially different. The two charts below capture the similarities between Greek and Spanish debt repayment profiles.



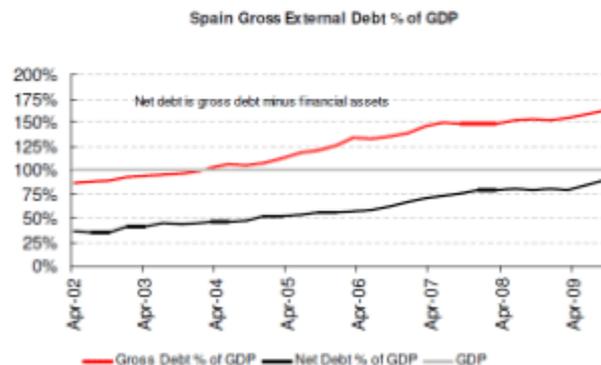
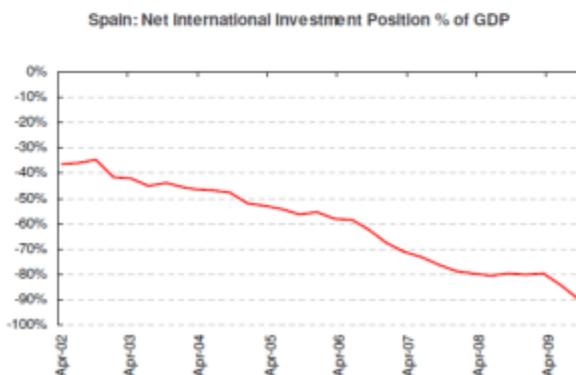
Source: Bloomberg

As of now, Spain needs to pay back 40% of all its outstanding principal and interest payments over the next five years, compared to a 50% figure for Greece. This is before taking into account disbursement of emergency loans from the EU and the IMF. Over the next ten years, Greece is due to pay back a sum equivalent to 60% of all its outstanding principal and interest, whereas for Spain it is 75%.

More immediately, Spain has to issue new debt plus roll existing debt this year to the tune of €225 billion, roughly a quarter of Spanish GDP. Spain's debt to GDP level is 54%, which is below the EU average, but Spain is showing the highest velocity of increase, and we believe it will reach 85% of GDP by 2014. Worryingly, more than half last year's increase in borrowing was financed by foreigners. Simply put, Spain is dependent on the kindness of strangers. The following chart shows the total stock of bonds (this does not include short term *Letras del Tesoro*).

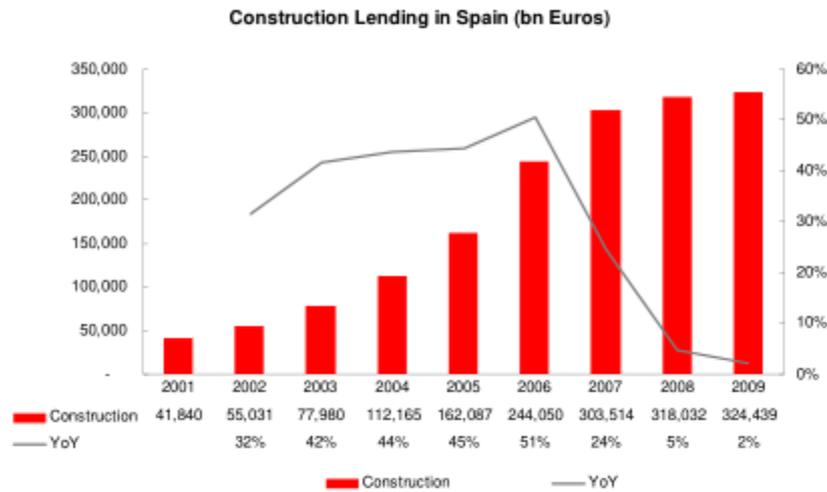


It is likely that foreign buyers will be fickle and could switch their holdings of Spanish debt into what they perceive to be safer assets very quickly. For Spain, the ingredients are there for a rout with much higher bond yields, should investors take fright. Furthermore, as the following charts of net international investment position, external debt and current account deficit show, Spain's cash flow situation remains terrible.



We believe that Spain has yet to experience a full scale deleveraging across the corporate and household sector. As the following chart shows, the European periphery was the epicentre of the largest domestic credit boom in recent decades. According to IMF data, growth in Irish and Spanish domestic lending even eclipsed China.

Furthermore, construction lending grew at 30-50% rates year over year for much of the past decade.



We do not know of any country that has experienced such rapid, sustained credit growth without experiencing a large banking crisis. The instances are few, but they are all extreme. Our view remains that the problems in the Spanish banking system are not over and we have yet to see the full fiscal burden of banking recapitalization.

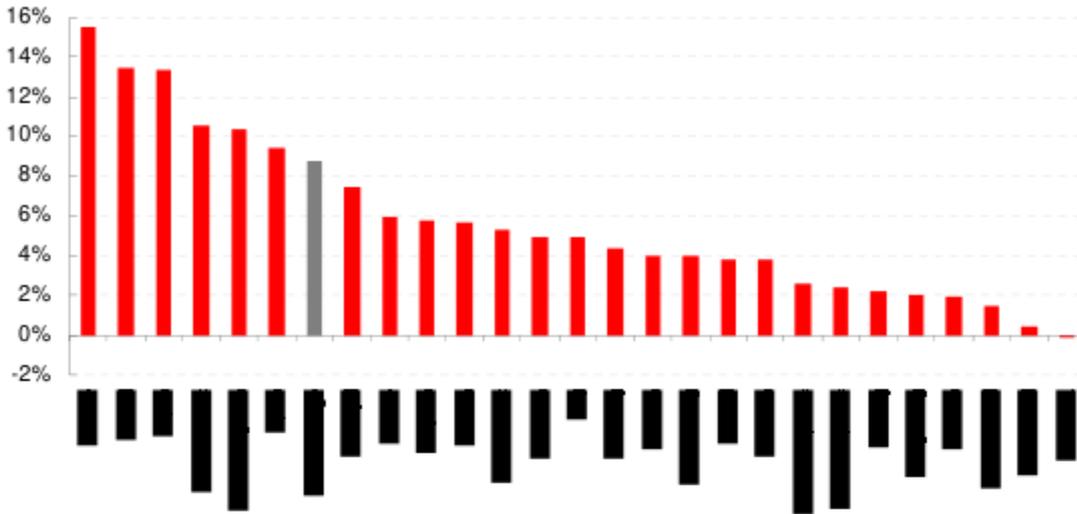
### **FISCAL CONSOLIDATIONS – THE UNASSAILABLE MATHEMATICS OF SOVEREIGN DEBT**

The dynamics of sovereign indebtedness can be cruel. As Greece's current predicament highlights, things can quickly get out of control. A downwards spiral of further indebtedness can develop as markets lose confidence in the country's ability to service its debts. Reducing debt to GDP levels is key to regaining the confidence of lenders. There are 3 main ways to do this:

- 1) Increase nominal GDP
- 2) Create inflation
- 3) Reduce the structural primary deficit

We can try to gauge the effectiveness of each of these using a simple model. We have assumed for our model the IMF's assumptions on the pace of reduction in the structural primary deficit (ie the cyclically adjusted budget deficit less interest payments) necessary to achieve a public debt-to-GDP ratio of 60% by the year 2030 (using their methodology):

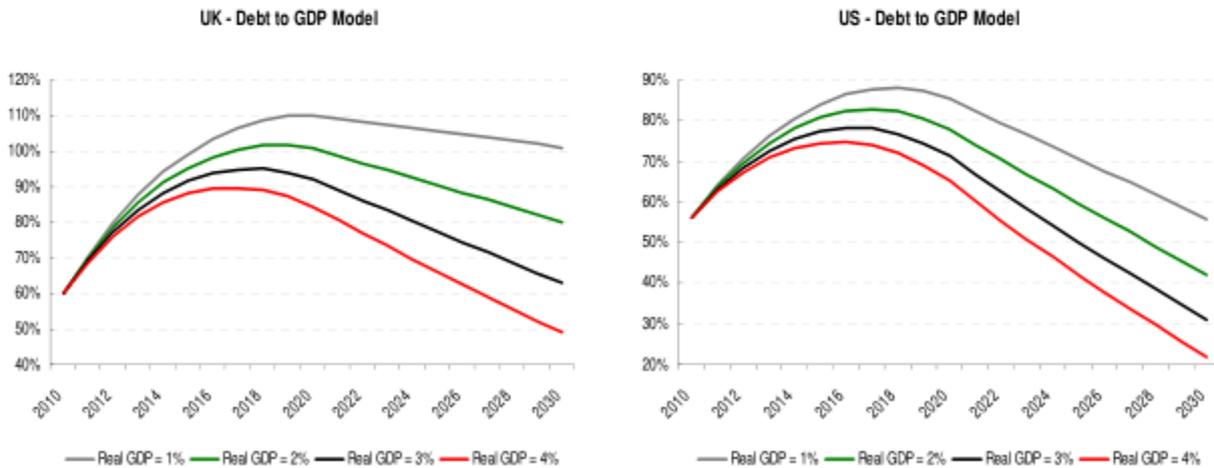
**Required Fiscal Adjustment between 2010 and 2020**



Source: IMF

For instance, for the UK, which requires an improvement of 10.4% between 2011 and 2020, this means the structural primary budget balance, currently at -6.2%, needs to turn into a 4.1% surplus by 2020. This is a hefty reduction of around 1% (of GDP) a year.

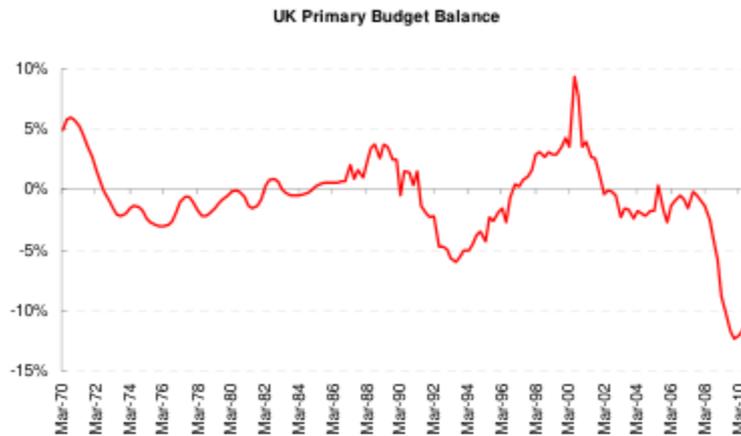
The following charts show the evolution of debt-to-GDP ratios for the UK and the US, using our own model with the IMF assumptions. As can be seen, the US's debt-to-GDP peaks at a lower level than the UK's and decays more quickly.



Source: Variant Perception

For the UK, out of the four growth rates shown, only under the assumption of a very high real GDP growth of 4% per year does the ratio not breach 100%, and then reduce to under 50% by 2030. A more realistic forecast of real GDP growth of 2% per year in the UK has the ratio peaking at over 100% in about 10 years, and falling back to a still elevated 80% in the year 2030.

How realistic are the assumptions? The UK has achieved a 10% reduction in its primary balance before, between 1994 and 2000, as the chart below shows:

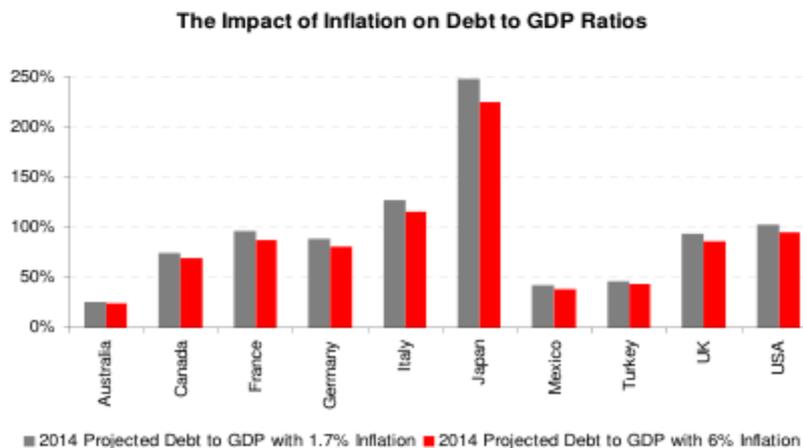


Source: OECD

However, nominal GDP grew by over 40% over that period, approximately 6% per year. With a backdrop of a heavy debt load across the private and public sectors and a synchronised slow down globally, it will be extremely difficult for the UK to achieve growth of anything like this in the coming years.

This argument also applies to the US, Japan, Spain, Greece and Ireland. The latter three are further constrained by being unable to weaken their currency to stimulate growth through exports (internal devaluations severely hamper nominal GDP growth).

Is inflation a viable way out to reduce debt burdens? Although increased inflation raises more revenue from seigniorage, and reduces the present value of (most) government debt, it also has the trade-off that issuing new debt becomes more expensive. As per their model, the IMF calculated the effects on debt-to-GDP ratios of several countries if they increased the assumption for average inflation to 6% (a 4.3%-pt increase), keeping everything else constant.



Source: IMF

As can be seen, the effect is minor. The 4.3% higher inflation rate reduces the debt-to-GDP ratio by an average of 8%-pts over 5 years.

A further assumption made in the model is that the effective rate of interest paid on sovereign debt remains where it is today. This is a big if, especially if inflation becomes a concern. In the US's case the effective rate of interest it pays is biased upwards as it has an explicit aim of increasing the average duration of its debt over the coming years.

And how difficult will it be for the US and UK governments to bring in the primary balance as per the IMF assumptions (approximately 1%-pt per year until 2020, then held constant until at least 2030)? This would involve hefty tax rises and significant austerity measures. However, the IMF has noted that with the top 10 largest reductions in debt ratios in developed economies over the last 30 years, it was the improvement in the primary balance that played the bigger part, not the performance GDP growth relative to the effective interest rate paid on sovereign debt.

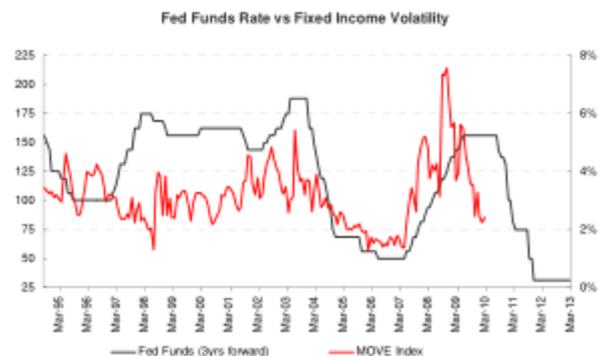
As the model we have used demonstrates, the mathematics of debt growth are unassailable and potentially explosive. Debt loads, once they become too big, are incredibly difficult to bring back under control, as Greece has so starkly demonstrated in recent weeks. **The most successful fiscal consolidations have been achieved not through high growth rates (relative to interest rates), or through the stoking of inflation, but by reducing the structural primary deficit.** Politically, this is tough to achieve, and difficult choices must be made.

If policymakers in developed, debt-burdened countries believe this is the way to go, we can expect many years of biting cost-cutting and tax rises. This is yet one more headwind struggling economies will have to battle against, ensuring many developed countries remain on the structurally lower growth trajectories they have been on for some time.

### POTENTIAL FOR BLACK SWAN "CREDIT ANSTALT" TYPE EVENT

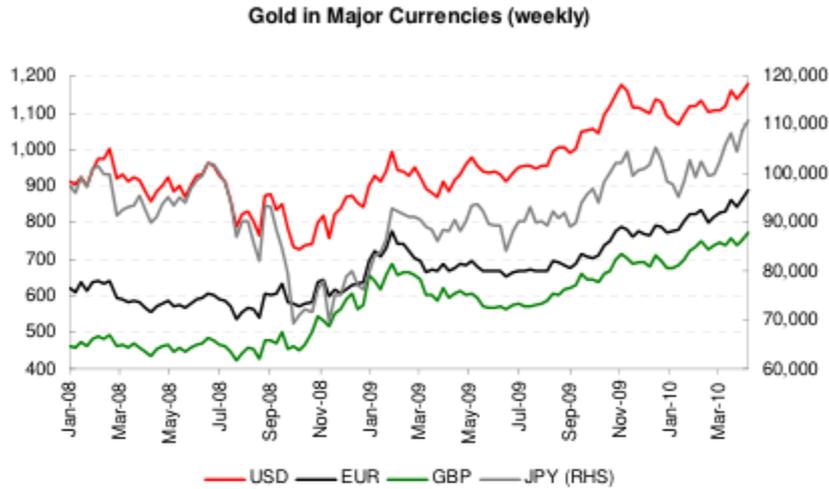
It is not our base case that we have another financial crash so soon, but we are vigilant to any extreme contagion events in the European periphery. We have flagged before that sovereign defaults tend to cluster, and they typically follow banking crises by two or three years. The main event that led to banking failures in the Great Depression was not the 1929 crash but the 1931 financial crisis that began in Austria because of the bankruptcy of Credit Anstalt in Austria, precipitated by a tightening of credit to the bank.

As we have written before, volatility follows the credit cycle. Given the massive credit binge of the last few years, we would be very surprised if we did not have further episodes of volatility.

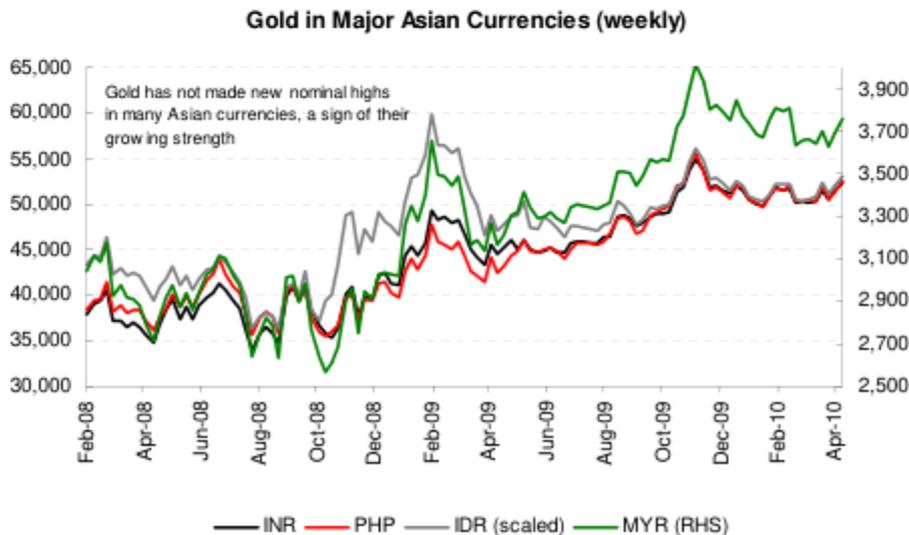


## GOLD: A HEDGE AGAINST SOVEREIGN CRISES

Gold remains our preferred hedge against profligate governments and abetting central banks. Indeed, conceptually, it is the best way to short central banks. Gold is currently making new highs in many currencies. We believe such broad based strength is particularly meaningful. Even in terms of the dollar, which has outperformed most currencies in the past three months, it has formed a medium term inverted head and shoulders.



One of our top themes for the year has been Asian currency appreciation. Although gold has risen against the main Asian currencies lately it has not yet made new highs. This is a testament to the strength of Asian currencies: they are rallying not just against currencies of debt-burdened developed nations, but are holding their own against gold.



Not only is gold rising in many currencies, its volatility is as low as it was 7 years ago, when gold was considered by many to be a moribund asset. We recommend being long gold and long gold volatility.

3 Month Gold Volatility



**EMERGING STRUCTURAL TRENDS**

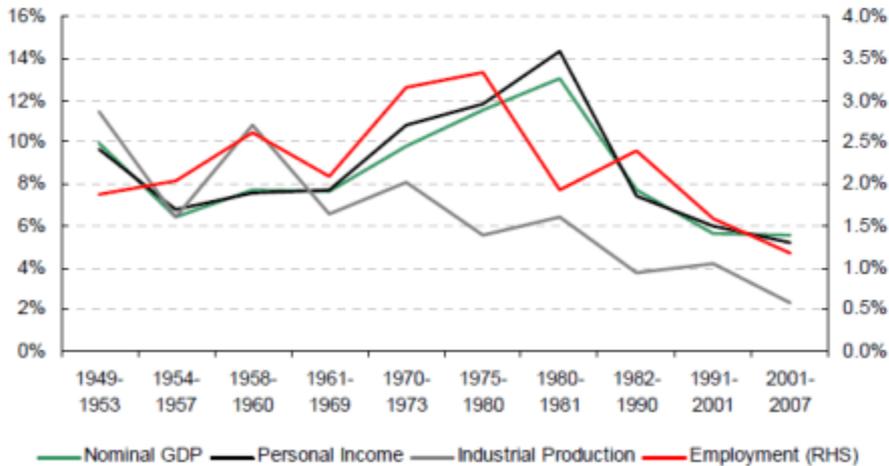
Investors are good at absorbing short term information. They are less successful at absorbing bigger structural trends and understanding when secular breaks have occurred. Perhaps investors are like the proverbial frogs in the frying pan and do not notice long, slow changes around them.

We believe there are three large structural changes that have important implications for the US economy and for asset allocation and positioning.

**1) LOWER TREND GROWTH: THE BEST YEARS OF GROWTH ARE BEHIND US**

Expansions aren't what they used to be. There is a clear trend down in many coincident indicators in the last several inter-recession periods.

Annual Growth of Indicators Through Expansions



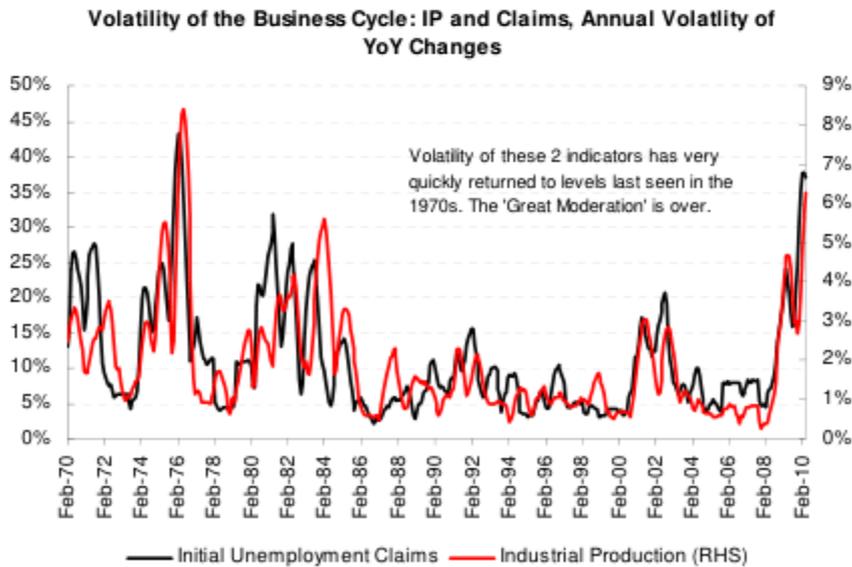
This trend can be seen here too. The rolling average of growth in US nominal GDP is now sub 1% compared to almost 3% 30 years ago.



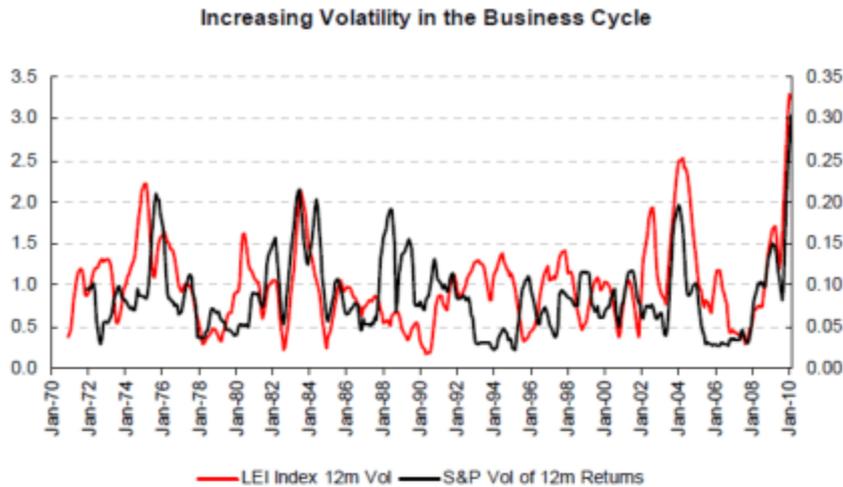
The implications of this are profound. The waning potency of expansions means recessions will be more frequent, as we bump along ever closer to the 0% growth bound.

## 2) HIGHER VOLATILITY: BIGGER UPS AND DOWNS

The period of low volatility of GDP, Industrial Production and Initial Unemployment Claims is now over. For a period of over twenty years, excluding the brief 2001-02 recession, volatility of real economic data was extremely low.



We believe that the recent spike in macroeconomic volatility will be sustained, as the volatility of leading economic indicators shows.



The two decades of lower economic volatility have been called 'The Great Moderation'. We believe going forward higher economic volatility combined with a secular trend down in economic growth will create the conditions for more frequent recessions (and its corollary, more frequent expansions).

**Investors will have to adjust to this new reality. Reducing leverage is one way. Another is to reduce the average holding period of investments. Investors will have to become more nimble. This in itself may add to market volatility.**

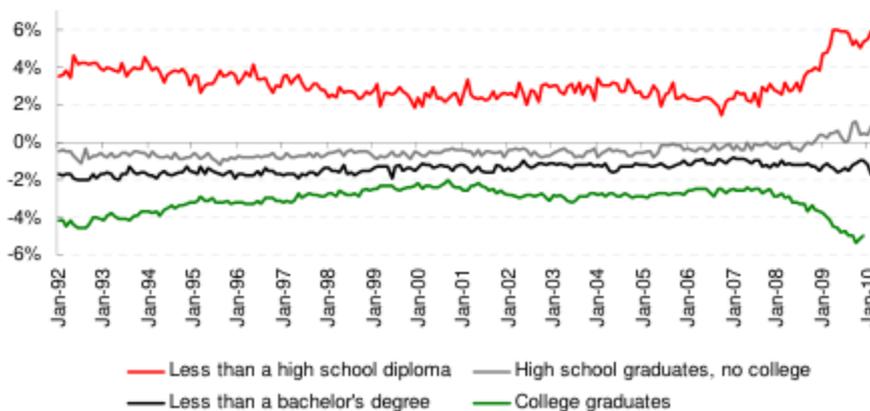
For longer term investors, this change of paradigm will mean achieving consistent solid returns becomes that bit more difficult. Investors with a shorter term, more tactical outlook may find these new, more volatile conditions a hotbed of profitable opportunities.

### 3) MANY UNEMPLOYMENT RATES: A MORE NUANCED LOOK AT UNEMPLOYMENT

There is a growing disparity in unemployment rates between the well-educated and the poorly educated; between the "haves" and "have nots." This is a structural shift that began before the recession and has grown only stronger during the recession.

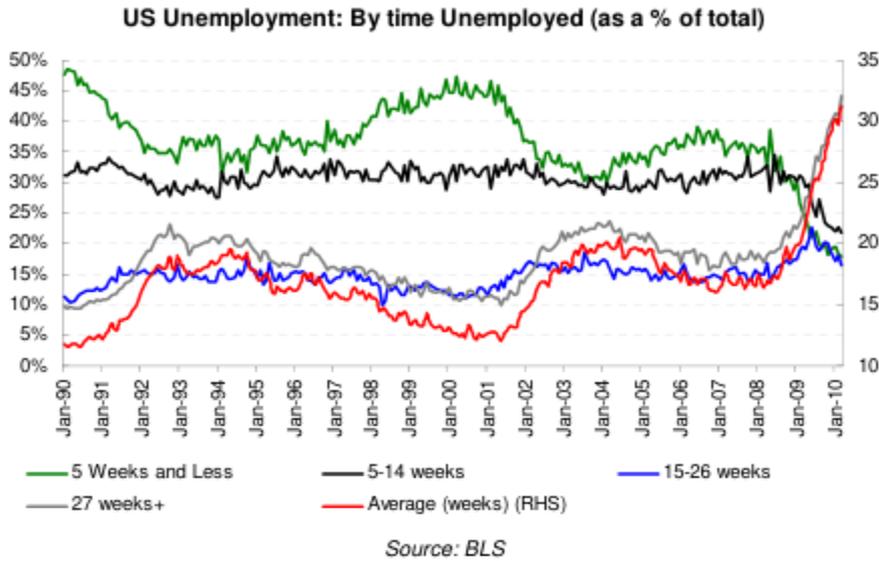
The disparity in the unemployment situation is far more dramatic if you look at the breakdown of unemployment rates by educational attainment.

**US: Unemployment Rate by Educational Level Above/Below Overall Unemployment Rate (SA)**



Source: BLS

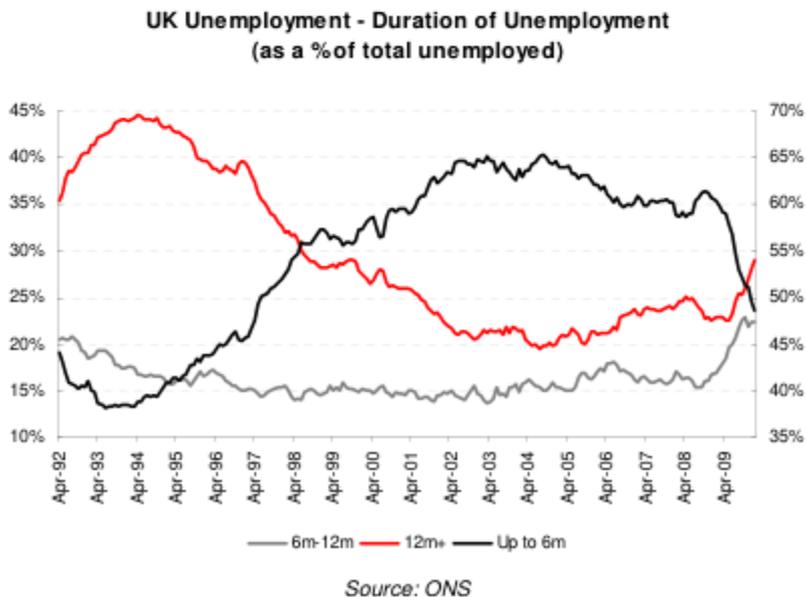
Also instructive is to look at unemployment by length of time unemployed.



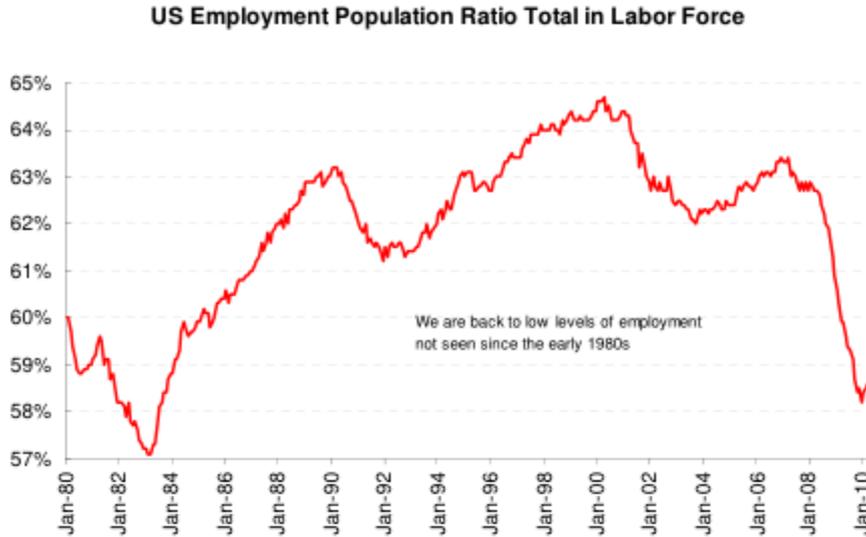
There are clear trends developing. Those who have attained a higher level of education are not suffering to nearly the same extent (looked at relative to the overall unemployment rate) as those on the lower end of educational scale. Indeed, conditions for higher skilled workers could be described as tight.

Furthermore, those who find themselves out of work are on average out of work for longer. The average time of unemployment has sharply increased from less than 20 weeks only 2 years ago, to over 30 weeks now – a 50% increase. Those unemployed for shorter lengths of time now make up much less of the total than they used to. The majority of unemployed workers is instead primarily comprised of those in a chronic state of being unable to find work. Such people find it ever harder to get back in to employment as their skills risk going into stagnation or obsolescence. This has huge structural implications.

This phenomenon is not confined to the US. A similar pattern is developing in the UK:



As workers are unable to find jobs, they drop out of the labour force:



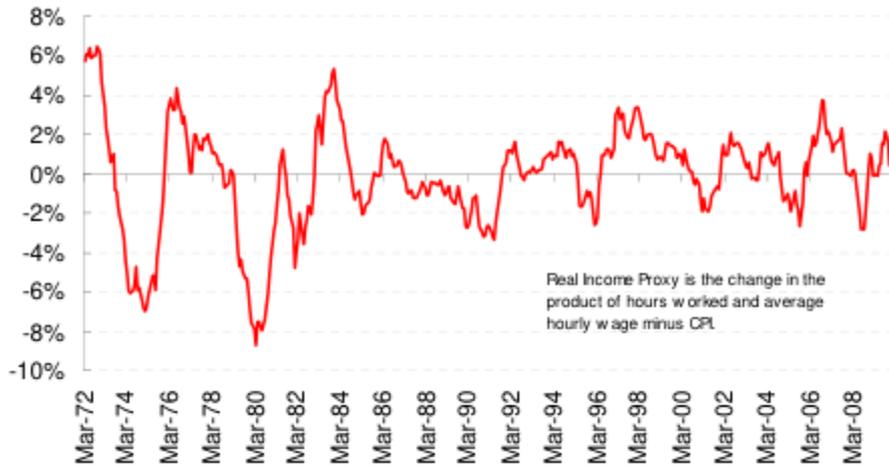
Again, this is not confined to the US. The UK's employment ratio is back to 1997 levels and continues to fall sharply. This puts the UK's 8% unemployment rate – low by historical standards for a recession – in to some context.



Source: ONS

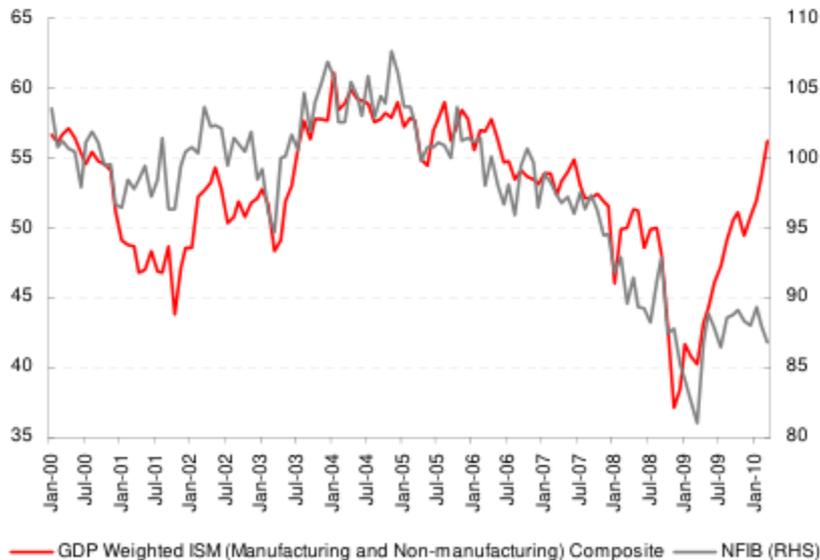
We believe the disparity in unemployment levels between high education and lower educational levels is part of a profound structural change in the labour market. The disparity will have significant investment implications and explains, for example, how Tiffany's can raise prices while Wal-Mart is in a discounting frenzy. As employment and wages stagnate at the lower end, any reflationary monetary policy will reduce real incomes of the poor. Once again the world is not black or white, but several shades of grey.

**Real Income Proxy YoY**



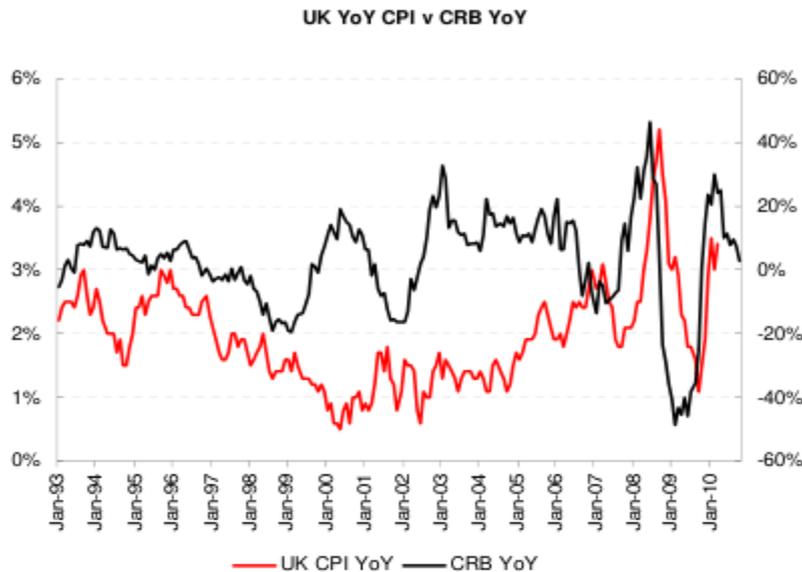
The divergence between the composite ISM and the NFIB Small Business Optimism Index also captures this growing disparity. Small businesses are key for job growth. 50% of the private workforce in the US are employed by companies of less than 50 people. Firms of less than 500 people employ 80% of workers.

**US ISM v NFB Small Business Optimism Index**



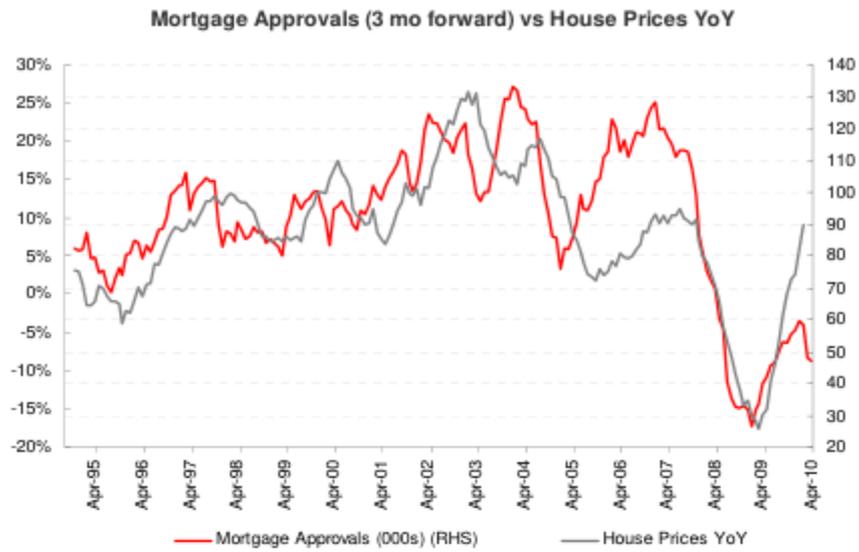
### UK: THE BANK OF ENGLAND KEEPS UNDERESTIMATING INFLATION

CPI in the UK has been supported lately the VAT rise in January. Rising energy prices, exacerbated by a fall in GBP, have also been a contributing factor. However, as the following chart of UK CPI and the CRB Commodities Index suggests, consumer inflation in the UK is perhaps near peaking (we assume the CRB remains constant from its current value and project forward its YoY rate):



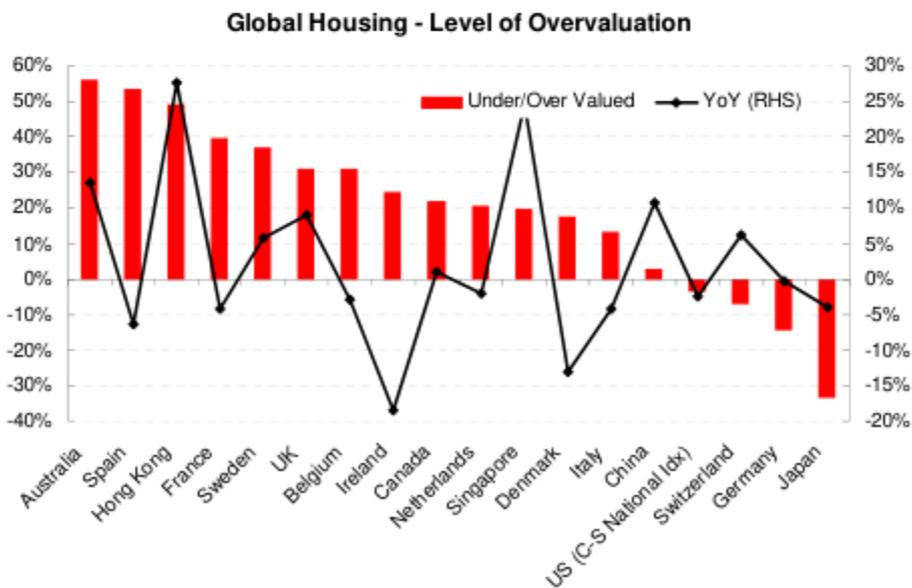
The RPI (Retail Price Index) on the other hand will continue to feel upward pressure. This is because RPI includes mortgage interest repayments. Although many fixed mortgage rates have fallen lately, they are likely close to bottoming as speculation intensifies that the BoE will begin to remove emergency monetary accommodation as early as the second half of this year. (Our belief is the BoE will be on hold for longer as it, like the Fed, focuses on *lagging* indicators, such as core inflation). This should support UK inflation linked debt which is indexed to RPI.

RPI will be further buoyed if house prices continue to rise. House prices in the UK are rising at over 10% YoY. However, the sustainability of such increases is called in to question when one looks at mortgage approvals. These staged a mini-comeback over the last year as stamp duty relief, among other measures, was introduced. As these have run their course, mortgage approvals have fallen back. Constraining borrowers more often these days is less the price or availability of mortgage financing, but obtaining the deposit. The average deposit for a mortgage in the UK has doubled from its 2007 level.



Jeremy Grantham of GMO, an investment management firm, looked at every historical bubble and found that all of them, eventually, move back to the trend that existed prior to the bubble forming. There are two outstanding however, and one of them is the UK housing market (the other is the Australian property market).

Indeed, according to estimates from *The Economist*, the UK has one of the most overvalued housing markets, based on the long-term average of the price to rents ratio:



Source: *The Economist*



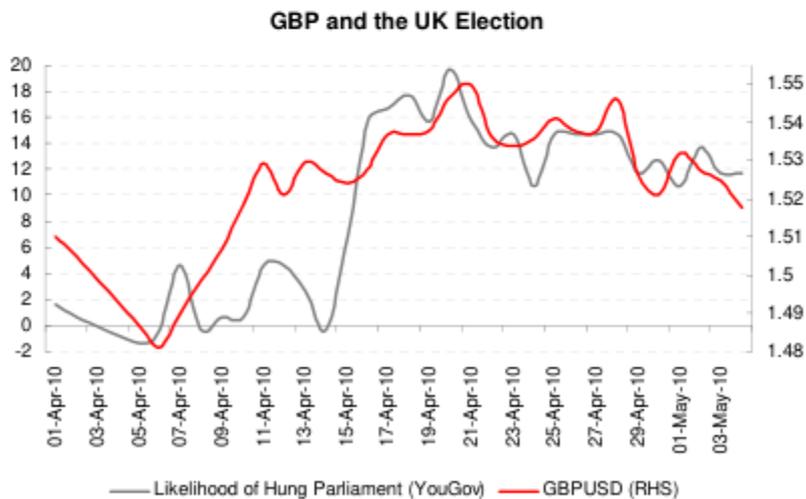
The other likely outcome is where no one party has a majority, ie a hung parliament. The last time the UK had a hung parliament was 1974. That parliament lasted only 8 months before another election was called and the Labour party won a working majority. A hung parliament this time may cause, at least initially, a great deal of uncertainty.

A hung parliament would mean more deal making and strategic alliances between the main parties. The Liberal Democrats, until very recently the unequivocal third party in UK politics, would be the so-called 'kingmakers' in any situation where no one party held a clear majority. The risk is legislation may be harder to pass due to consensus, rather than conviction, politics becoming the name of the game. Given the UK's fiscal predicament, tough measures will need to be taken quickly to quell lenders and secure the country's AAA credit rating.

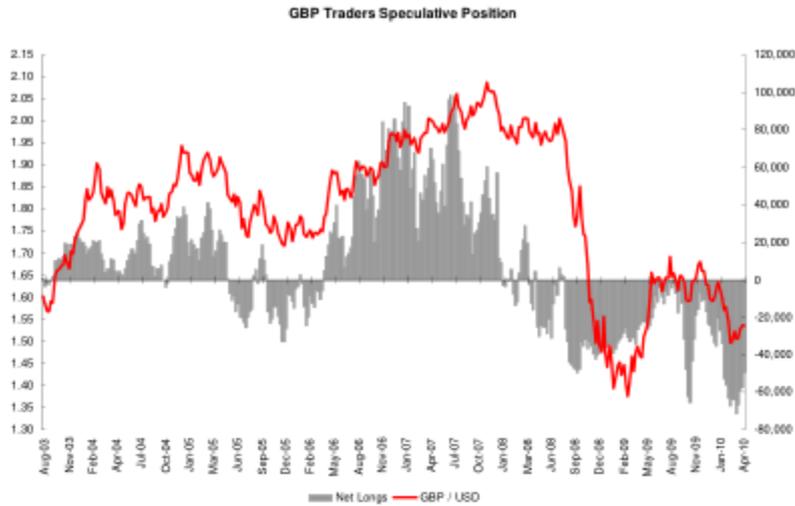
It has been highlighted that some of the most successful fiscal consolidations in the last 40 years have in fact taken place in countries with coalition governments. However, most of these had fixed election dates in the future which forced all parties to focus on a hard deadline. With no fixed-term parliaments, the UK will not have this advantage.

In sum, whether the election produces a slim majority for a Conservative party with a mandate that does not stretch to regions that will be heavily impacted by its policies, or it produces the potential for deadlock with a hung parliament, it is likely the uncertainties and unknowns will create fertile ground for a rise in sterling and gilt volatility in the short and medium term.

Indeed, GBP has begun to react to political events. The chart below shows that GBPUSD became sharply more correlated to the likelihood of a hung parliament from mid April (after a television debate hugely raised the profile of the Liberal Democrats and threw much uncertainty into the election result).



While a hung parliament may be negative for GBPUSD, it is not a clear cut case. Additionally, the potential for short-covering/profit-taking is high. As the chart below of GBP positions (from the Commitment of Traders report) shows, speculators are almost as short as they have been for at least 7 years.



This is why we would prefer to be delta-neutral and play for a rise in volatility. A muddled outlook, imminent fiscal tightening, a new politics for the UK, levels of uncertainty not seen for decades - these will all be positive for GBPUSD volatility in the coming weeks and probably months. We are buyers of GBPUSD straddles and delta-hedged GBPUSD out-of-the-money puts.

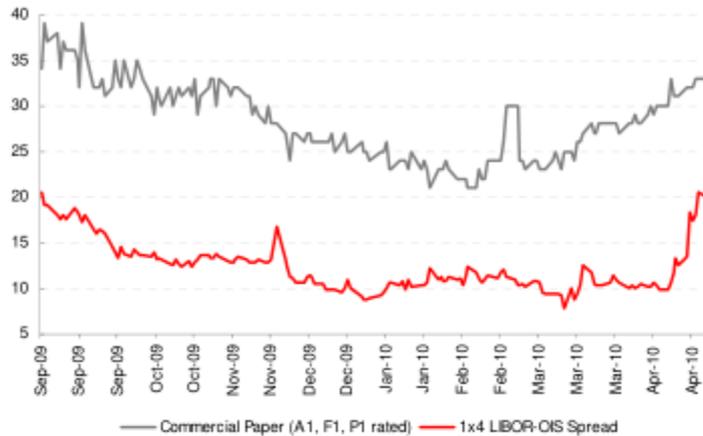
### TACTICS

In the last monthly we flagged many equity sell signals. Most are still in place. Complacency in the stock market is still at extremes. The ratio of short term volatility to medium term volatility is near all time lows. Typically, low readings in this measure have marked short term tops and have indicated extreme investor complacency.



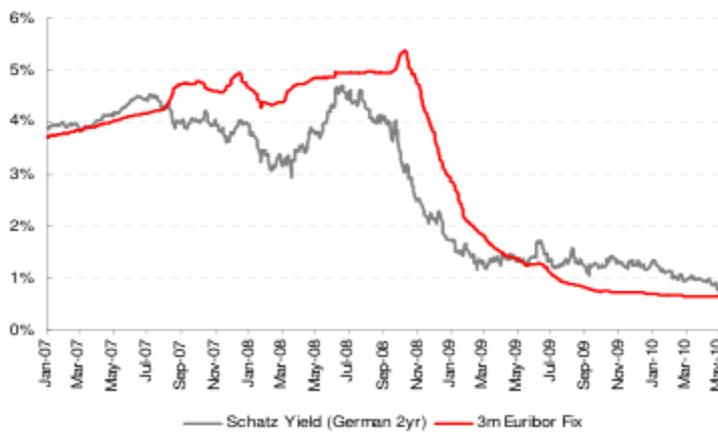
Divergences are abounding between equities and credit. We like to take our cue from spreads and money markets. Credit spreads are showing some signs of stress. Commercial paper rates are moving up and the FRA-OIS spread has started to widen. It is unlikely many traders will want to take the other side of this spread given the experiences of 2007 and 2008.

**Credit Spreads (in bps) - Creeping Up**



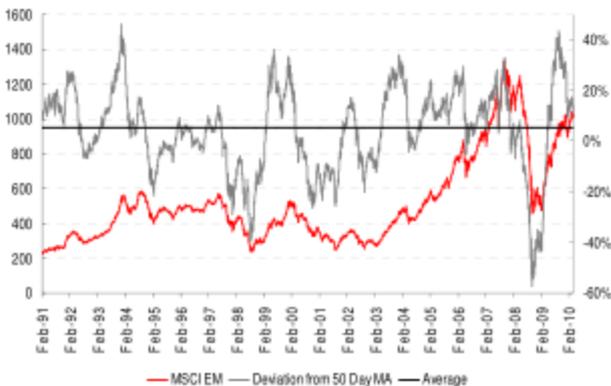
And the 3 month Euribor fix has just crossed above the Schatz (German 2yr) yield for the first time since August 2007:

**European Credit Stress**

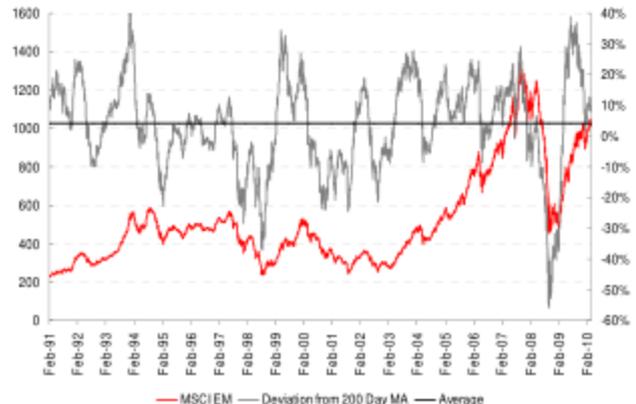


Unlike the - until very recently - complacent, almost euphoric readings in the US and developed markets, emerging markets have been less extreme. Our own Mania and Panic indicator, which measures appetite for risk assets across geographies, shows that readings are neutral, and emerging markets, in aggregate, do not look particularly overbought here.

**MSCI Emerging Markets**



**MSCI Emerging Markets**



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