Game-Changers in the Era of Dissonance

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September 2012

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Game-Changers in the Era of Dissonance

Rates: Lack of market confidence in the US and other mature countries

Energy: Crude oil versus natural gas

FX: Currency carry trades in a ZIRP environment

Agriculture: Volatile weather, politics and global demographics

Equities: Taking advantage of US core strengths

Metals: Slowing demand from the BRIC nations

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Lack of Confidence is Reflected in Long-Term US Treasury yields

Currently, there are essentially zero inflation-adjusted (real) yields on US Treasury 10-Year Notes.

Zero real long-term yields in US Government securities underscores the lack of confidence in the economic leadership of the mature industrial countries and a fear of the economy moving back into recession and experiencing deflation.

Zero real yields on long-term US Treasuries are not sustainable – either we spiral downward into deflation (very low probability) or the capital markets demand higher returns above inflation for taking long-term risks.

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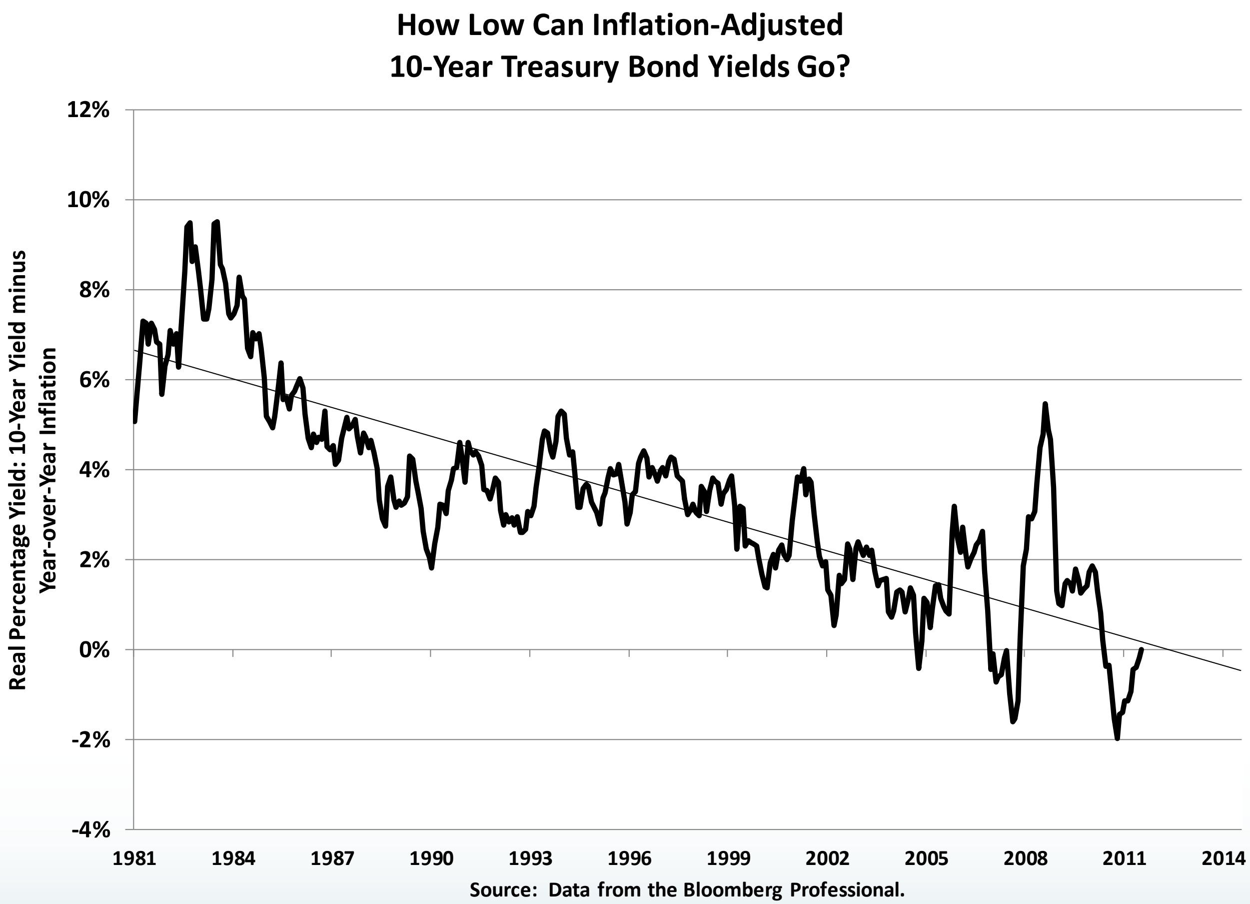
US 10-Year Treasury Inflation-Adjusted Yields



Why is the Federal Reserve so concerned about the economy?

The US economy has reeled off 12 straight quarters of real GDP growth since Q3 2009 averaging 2.2% growth.

The unemployment rate has fallen from its peak of 10% to just above 8%

US large corporations are flush with very large cash holdings,.

The US banking sector has recapitalized itself since 2008 and is now comfortably profitable.

Why is the Federal Reserve so concerned about the economy?

The Fed considers the current pace of real GDP growth (2.2% over the last 12 quarters) insufficient to bring down unemployment toward 6% (currently just above 8%, peaked in 2009 at 10%).

The Fed is worried (as are many others) about the potential for a highly disruptive fiscal cliff in 2013 if the US Congress cannot agree a long-term budget compromise.

The Fed is worried about the potential for global financial disruptions from fall-out from the European sovereign debt debacle.

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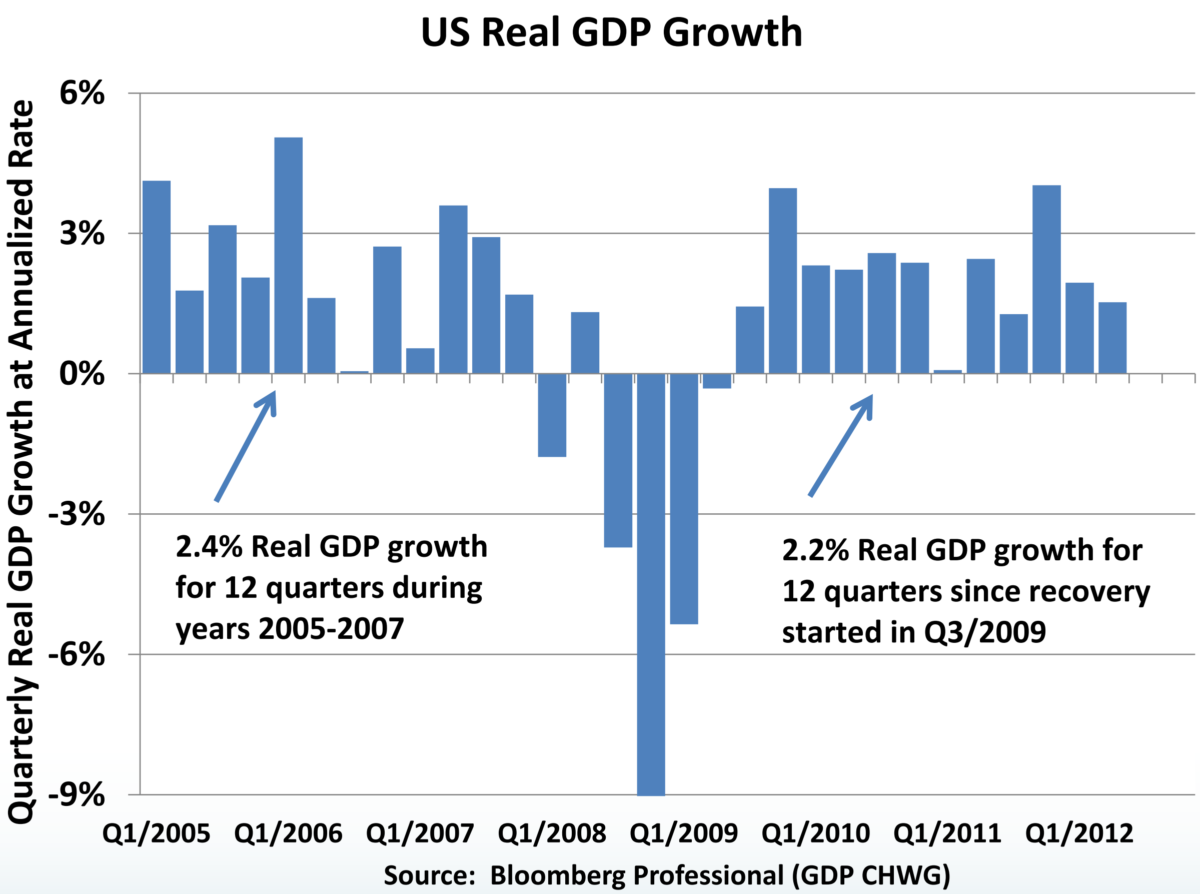
US Real GDP Growth in the last 12 quarters has been in line with pre-crisis growth.



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Why has the US economy not grown more rapidly since the recovery started in Q3/2009?

Global Headwinds

US Labor Force Challenges

Global Headwinds

- **Europe is somewhere between recession and stagnant as it copes with its sovereign debt debacle**
  - **Germany and France struggling to grow slowly**
  - **Spain and Italy in recession**
- **China's growth is slowing as it copes with decelerating export growth (20% of its exports go to Europe) and attempts to shift from an infrastructure-building growth model to a consumption model.**

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US Labor Force Challenges

Labor force growth is much slower than it was in decades past.

The average age of the labor force is higher than it was in decades past.

The relative cost of labor has risen substantially compared to the cost of capital over the last 30 years or so.

Technological change over the past 25 years has improved labor productivity while making it possible for corporations to use less labor when they expand and modernize.

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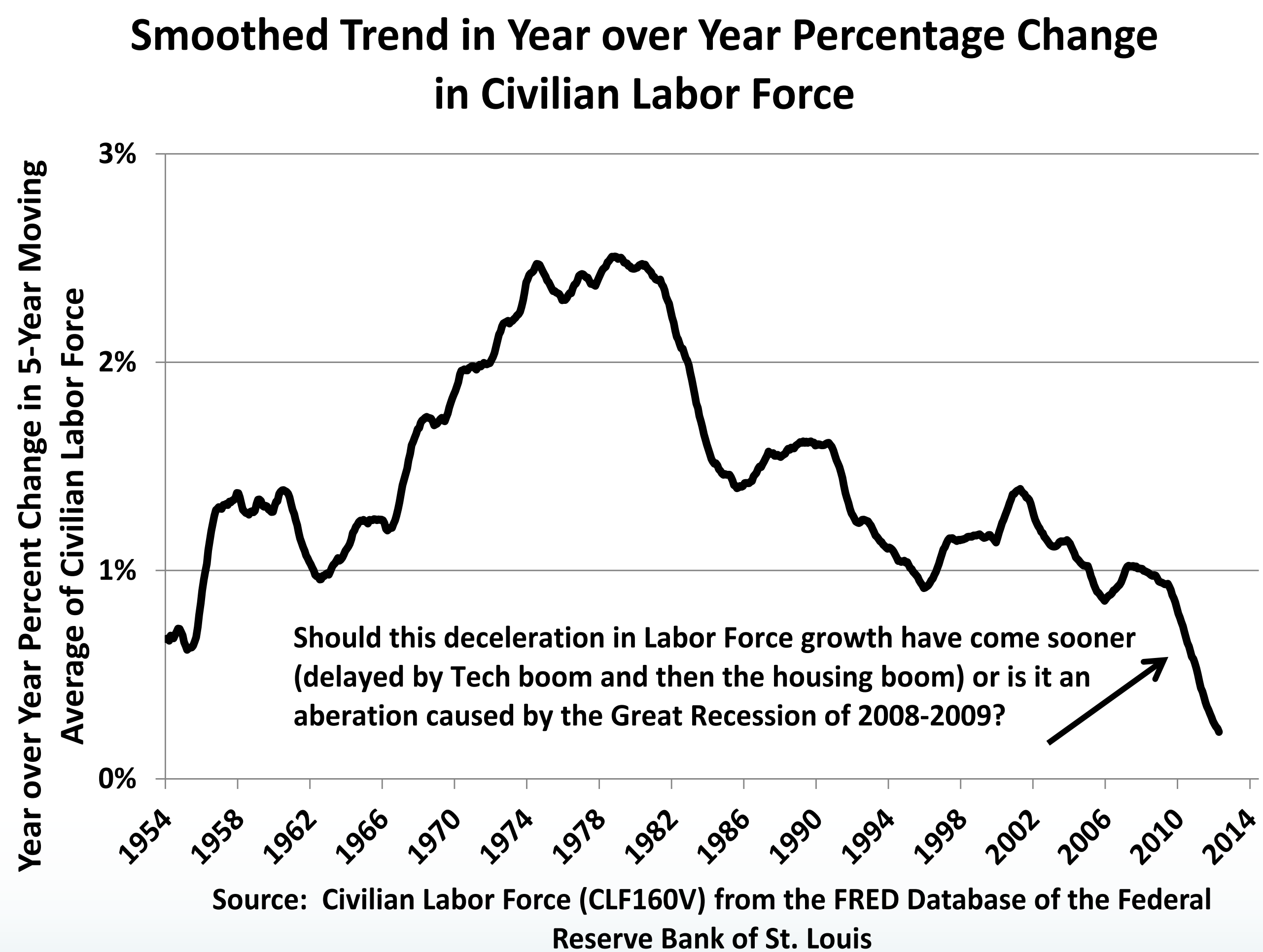
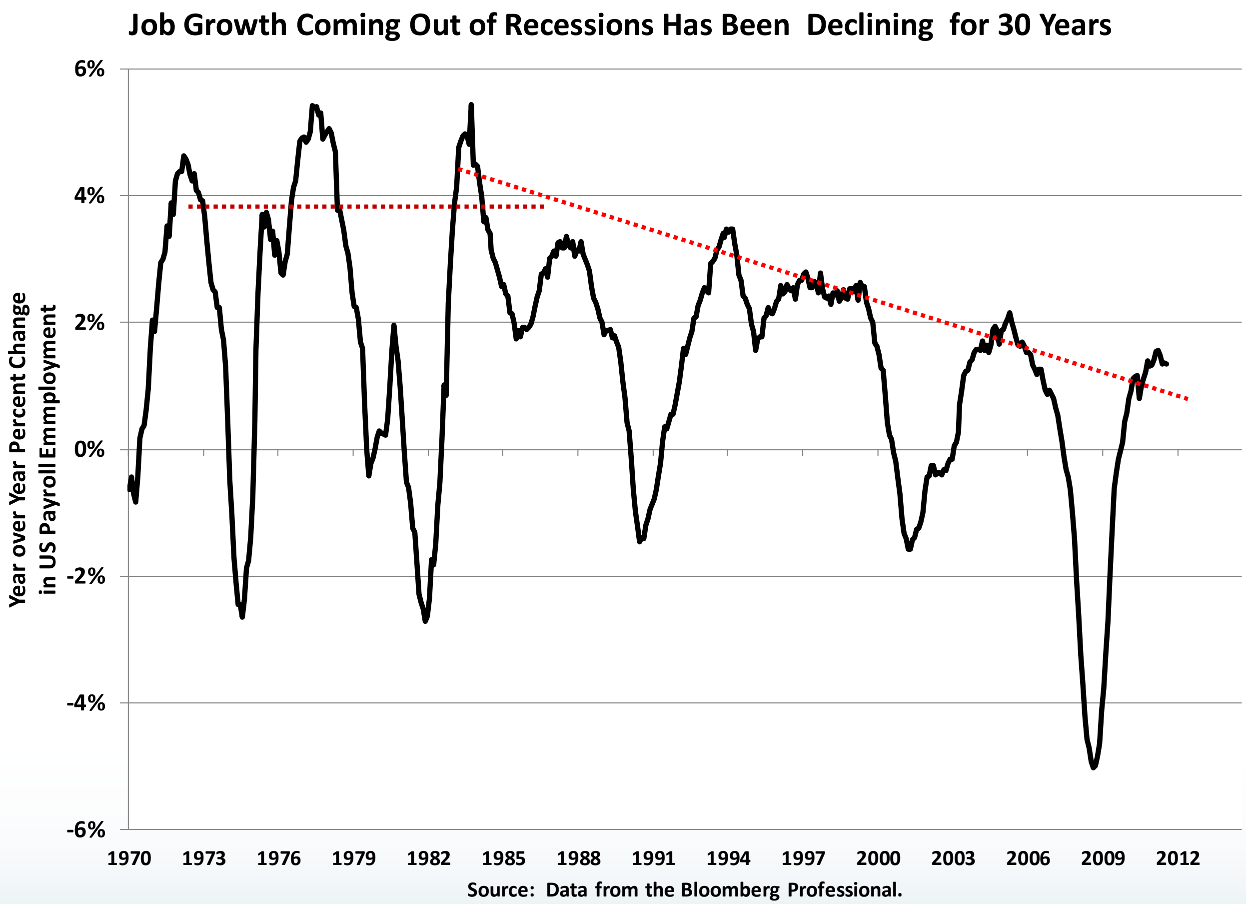
Slowing US Labor Force Growth



Consequences in the US of Rising Relative Cost of Labor Compared to Capital



US Policy Uncertainty

Unless the US Congress acts, taxes will rise in 2013 (expiration of Bush-era tax cuts) and government spending will be cut sharply (sequestration related to previous Congressional legislation designed (unsuccessfully) to force a long-term compromise.

The Federal Reserve’s policy of quantitative easing, operation twist, and near-zero rates for the foreseeable future is now hurting the economy and risking long-term damage.

The first round of Quantitative Easing (QE-1) in late 2008 and early 2009 helped prevent a financial crisis turning into a depression.

QE3, continued Operation Twist, and guidance that the federal funds rate will stay near zero into 2015 may be depressing confidence and hindering faster economic growth.

Problems with Extended Emergency Policies from the Fed

US Treasury and related rates markets face a distorted yield curve with long-term yields not offering any return over inflation.

Investors in search of yield are potentially creating a bubble in high yield bonds that presents serious long-term risks to the economy.

Savers and pensioners have had to cutback consumption since they depend in part of the yields from their (conservative) fixed income portfolios. This also impacts the younger generations that may need to assist their elders.

Low long-term Treasury yields further advantage capital relative to labor, so even if corporations expand, they will favor labor-saving technologies.

Low rates do not stimulate corporate investment plans – confidence in the future and a willing to take risks is what is required.

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Energy Sector Challenges

Rising Supply

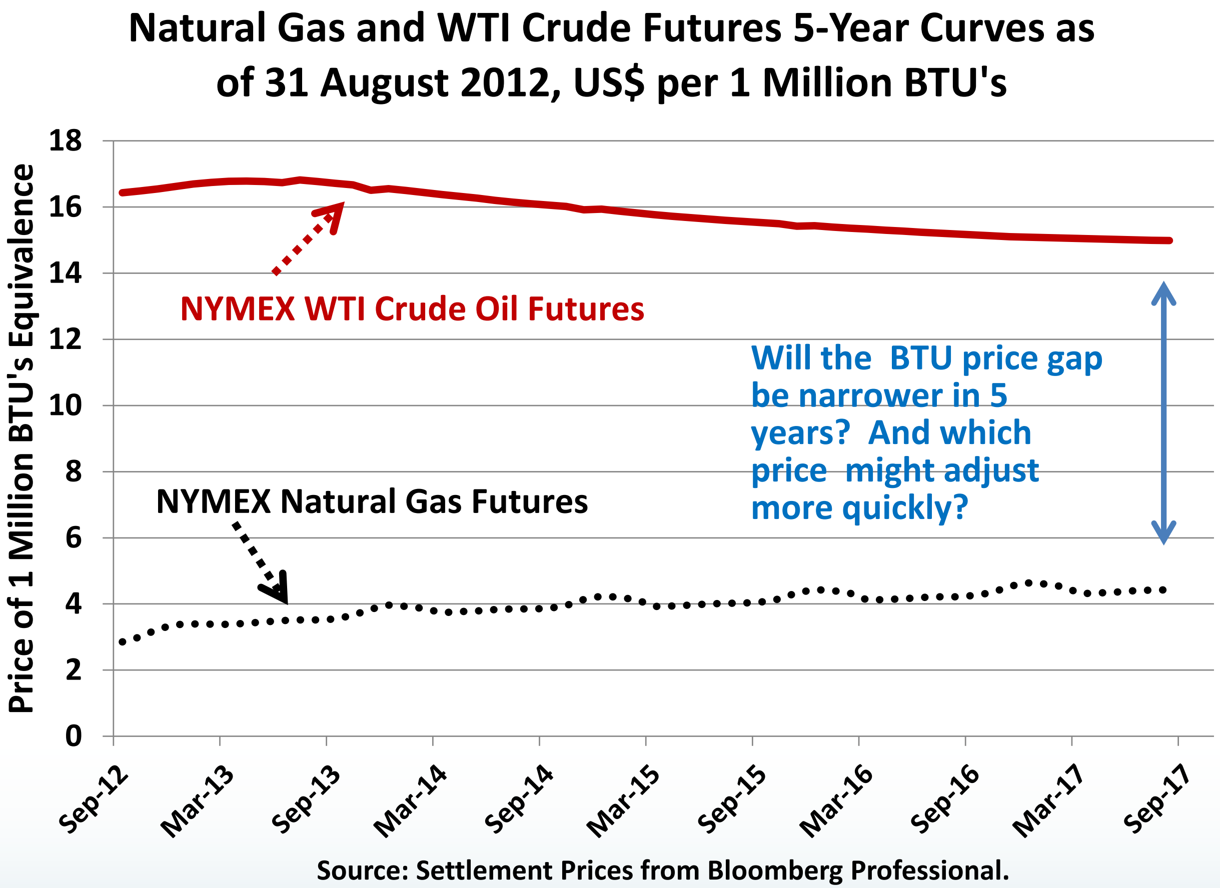
Meets

Slowing Demand

and

Infra-Structure Bottlenecks

Natural gas offers an extremely low cost per BTU of energy



Energy Demand: A Tale of Two Decades

From 2001-2010, Emerging Market nations grew at superlative rates and drove global commodity and energy demand higher.

In the 2011-2020 decade, Emerging Market nations will still lead the way, but the pace of growth is likely to slow dramatically from the previous decade.

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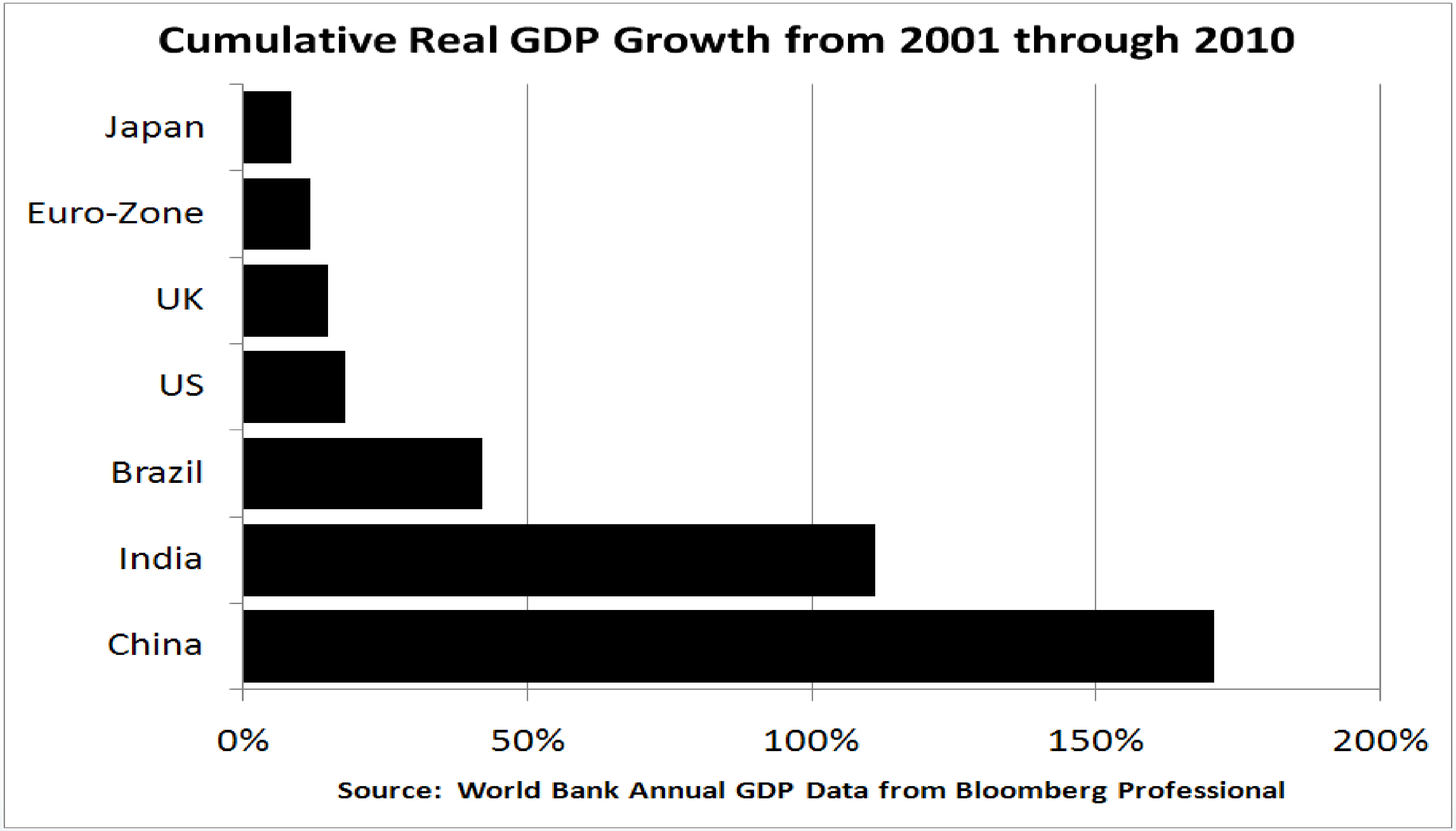
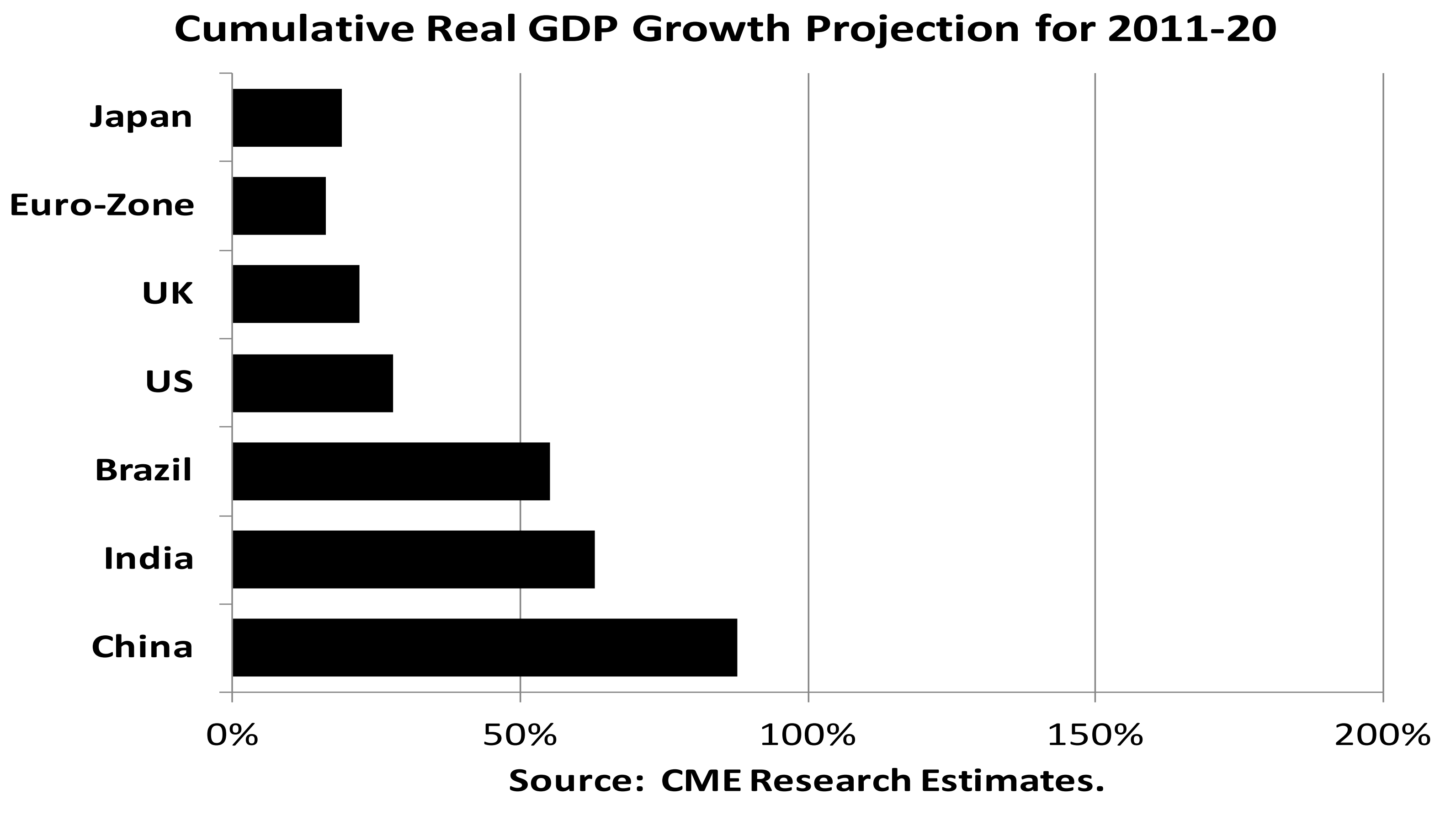
Economic Growth Divide (Last Decade)



Economic Growth Divide (Coming Decade)



FX in ZIRP World

The central banks in the US, UK, Euro-Zone, and Japan are all committed to extended periods of near-zero short-term interest rate policies (ZIRP).

The mature commodity producing countries, such as Australia, and the emerging market nations, from Mexico and Brazil in Latin America to India to China are likely to maintain interest rates between 3% and 6% (or more) above those in the US, UK, Euro-Zone, and Japan.

This makes investments in the currency carry trade very attractive, even relative to the substantial risks. However, when market fears (i.e., Europe debt crisis, US fiscal cliff, etc.) dominate, risk-off trading will close these positions down. These carry positions will get reestablished as global market fears calm.

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FX and Rates Example of Tools and Goals: The Volatility Balloon with US and Brazil

Brazil SELIC Rate				**US Federal Funds Rate**
		Joint Interest Rate & Exchange Rate Market Volatility		
Spot BRL/USD FX Rate				**Forward BRL/USD FX Rate**

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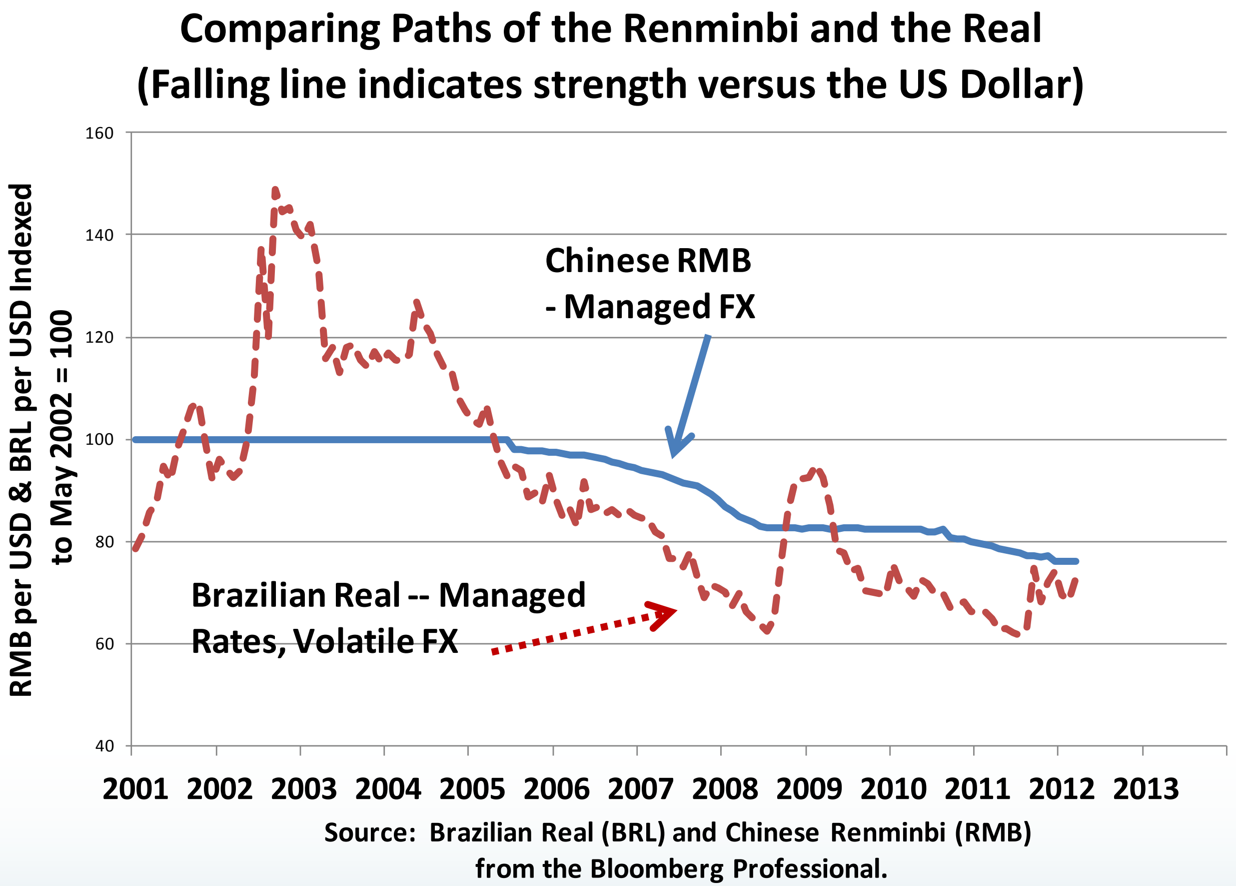
China & Brazil
Exchange Rate Paths



Agriculture, Politics and Weather

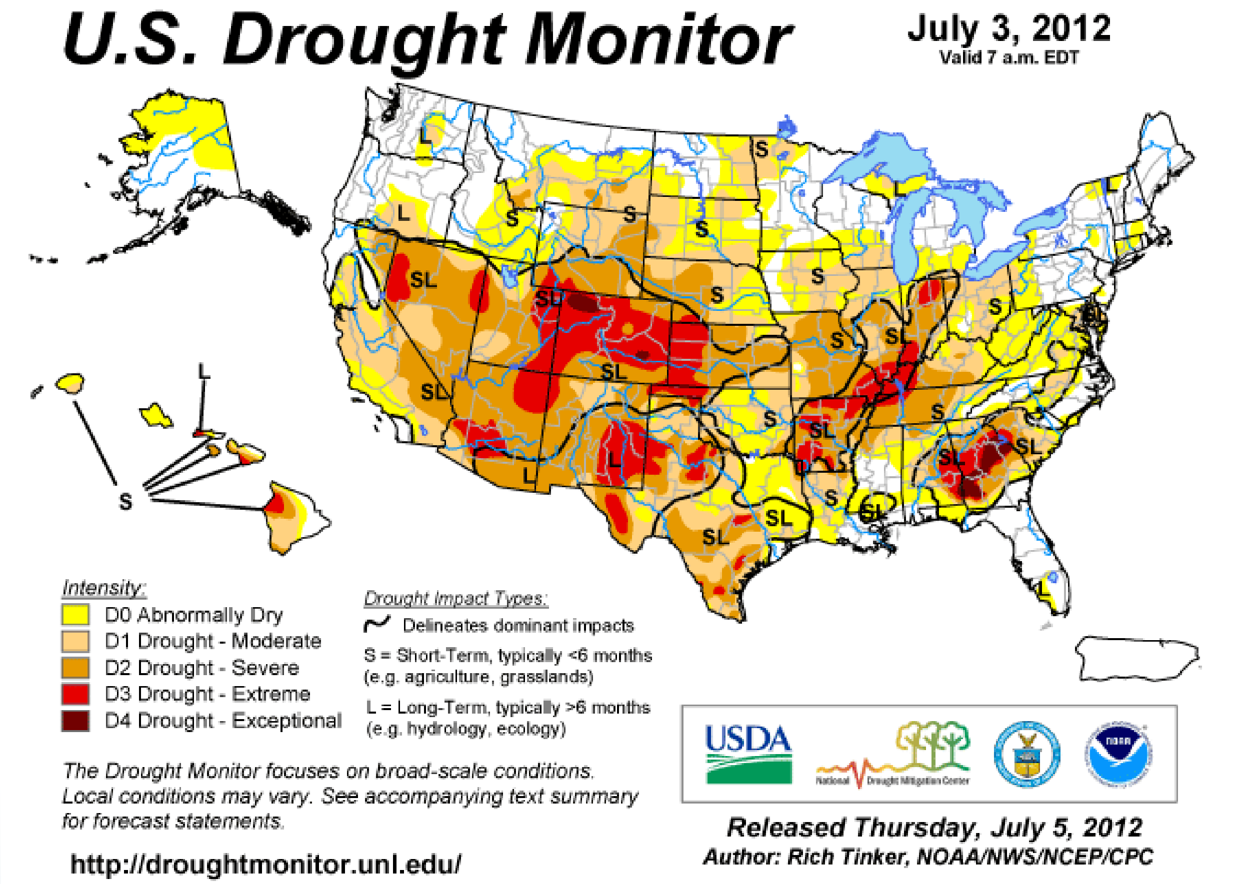
Changing food demand from growing middle classes in emerging market countries

Weather – droughts, changes of ocean temperatures and currents, increased volatility

Politics swing away from subsidizing bio-fuels

High likelihood of continued volatility and upward price trends across the agricultural sector

Source: NOAA


U.S. Drought Monitor
July 3, 2012
Valid 7 a.m. EDT
Intensity:
D0 Abnormally Dry
D1 Drought - Moderate
D2 Drought - Severe
D3 Drought - Extreme
D4 Drought - Exceptional
Drought Impact Types:
Delineates dominant impacts
S = Short-Term, typically <6 months (e.g. agriculture, grasslands)
L = Long-Term, typically >6 months (e.g. hydrology, ecology)
The Drought Monitor focuses on broad-scale conditions. Local conditions may vary. See accompanying text summary for forecast statements.
http://droughtmonitor.unl.edu/
USDA
Released Thursday, July 5, 2012
Author: Rich Tinker, NOAA/NWS/NCEP/CPC

Equities: Taking advantage of US core strengths

For over 35 years, the US has led other nations by having the highest average age group

Compared to the Japan, the UK, and Euro-Zone nations, the US has been best of class in important categories:

Best real GDP growth rate over last 12 quarters (since recovery started)

Best capitalized and most profitable banking sector

Strong potential for the S&P500 to outperform peers, as well as for sector rotation to gain traction as an investment approach for the coming years.

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Metals: Slowing demand from the BRIC nations

The phenomenal growth of the emerging market countries led by the BRIC nations in the past decade fed the rise in metals prices. One cannot build a country without copper, for example.

Now the BRIC nations are slowing.

There is likely a secular decline in long-term real GDP growth rates toward more sustainable paths, and

There is also a further temporary deceleration due to the financial turmoil in Europe and not helped by the fiscal cliff uncertainty in the US.

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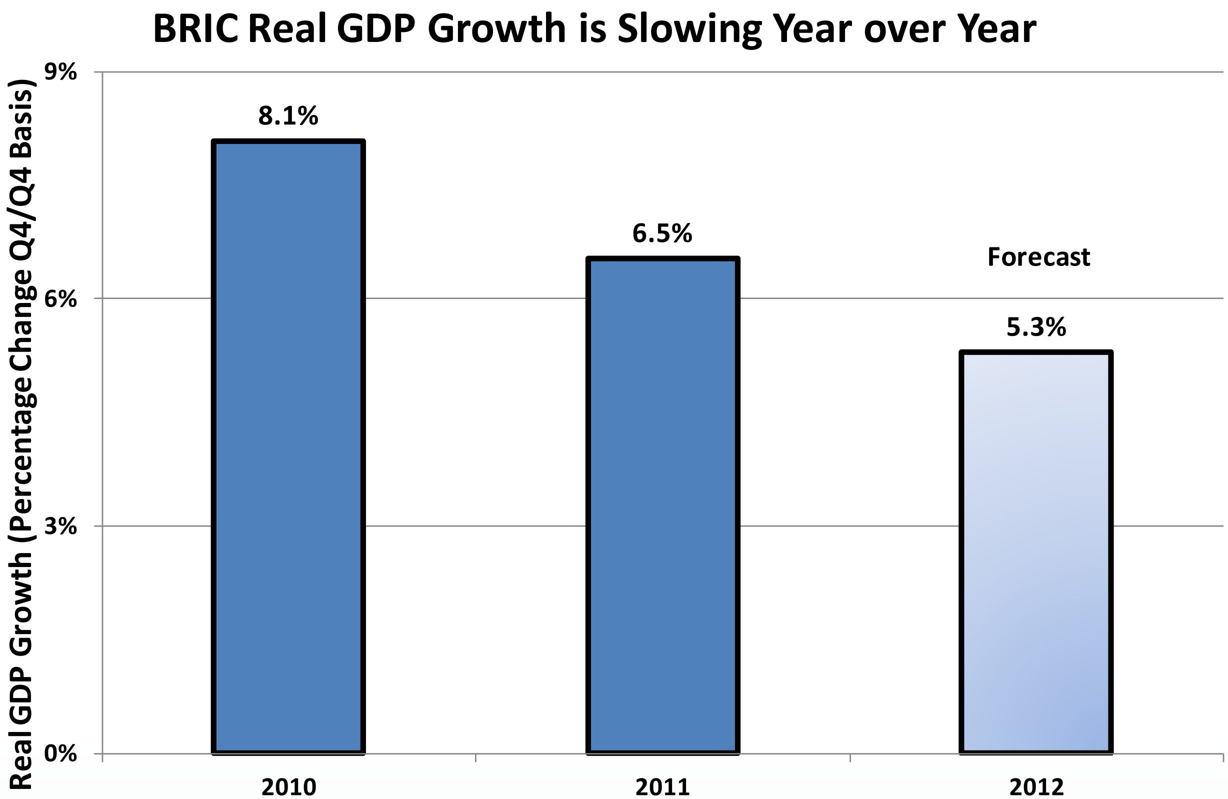
Slowing BRICs



Source: Real GDP data from the Bloomberg Professional, CME Economic Research for Aggregation of Growth Rates and Forecasts

Metals Outlook

Gold is supported by zero rates in the US, UK, Japan, and Euro-Zone. Gold demand is dampened to the extent of economic slowdowns in India and China – major gold buying nations. With near-zero rates as far as the eye can see from the Federal Reserve and the ECB, any recovery in BRIC nation economic growth in 2013 and beyond has the potential to push gold higher, albeit with considerable volatility.

Copper demand stems from infrastructure building. China is critical. China slowed infrastructure spending plans in 2011 and 2012, but there are signs that China will start spending again to get the economy moving faster 2013.   Copper is likely to be very volatile, and China is the country to watch.

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