

Some Asset Behavior when Government Resists the Natural Order of the Universe

By JM

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It's the holiday season and we all turn to the to-do list...getting lost in a sea of people at parties...finding a hook-up charged with sparks and magic... picking confetti out of your champagne...making ganja butter for the pancakes...caroling at the whorehouse...*scaling down those 3x long effs.*

Reducing risk should be written on your dreidel because Japan is the history of the future. Not just for the United States: the whole world. There are market forces bigger than any government action in play now; and in fact, policy makers trying to save the world have cemented it. Some call it the "new normal". I call it Japanification: the slow entropy of leverage in semi-controlled reverse. The alternative is to let it all go in one smoldering champagne supernova. But all the hyper money printing and WWII grade stimulus just falls in a financial black hole so strong that not one penny will ever escape.

I'm surprised so many people disagree about Japanification. It's been going on in the United States for nearly a decade. There are variations from country to country, but here's what it means in broad brushstrokes.

- Bursting of an *equity* bubble triggers an economic shock
- Policymakers react by lowering interest rates to increase liquidity
- Resulting *credit* bubble in RE and CRE bursts
- Policymakers respond by printing and throwing money at the problem.
- Financial system instability persists because *money printing is reactive, not proactive*
- Bankruptcy of major banks trigger a financial meltdown
- Turning major banks into undead zombies or outright nationalization
- Resulting *sovereign* debt explosion
- Policymakers respond by quantitative easing
- Central bank balance sheet indicates debt bubble
- (Forthcoming in Japan) Rising Treasury yields (in spite of deflation) pretty much crush everything
- (Forthcoming in Japan) Government firewalls off its own credit risk by cutting spending and raising taxes

I didn't say anything about economic growth. Real growth is possible, albeit with quick reverses into contraction. And I haven't said anything about inflation. Japanification—from aging developed economy demographics to consumer debt reduction to drying up corporate free cash flow to banks not lending to lower tier credits at all to unemployment rises all over the globe—has no place for inflation. Inflation can only occur after bubbles stop popping.

Governments are fighting deleveraging in various ways. For example, Ben Bernanke actually *pays* banks interest on their excess reserves, guaranteeing a deeper credit crunch. Sweden on the other hand actually *charges* banks via [negative interest rates](#) to park excess reserves¹. As creative and decisive as Sweden is from a policy perspective, it really just shows absolute panic in the face of reality.

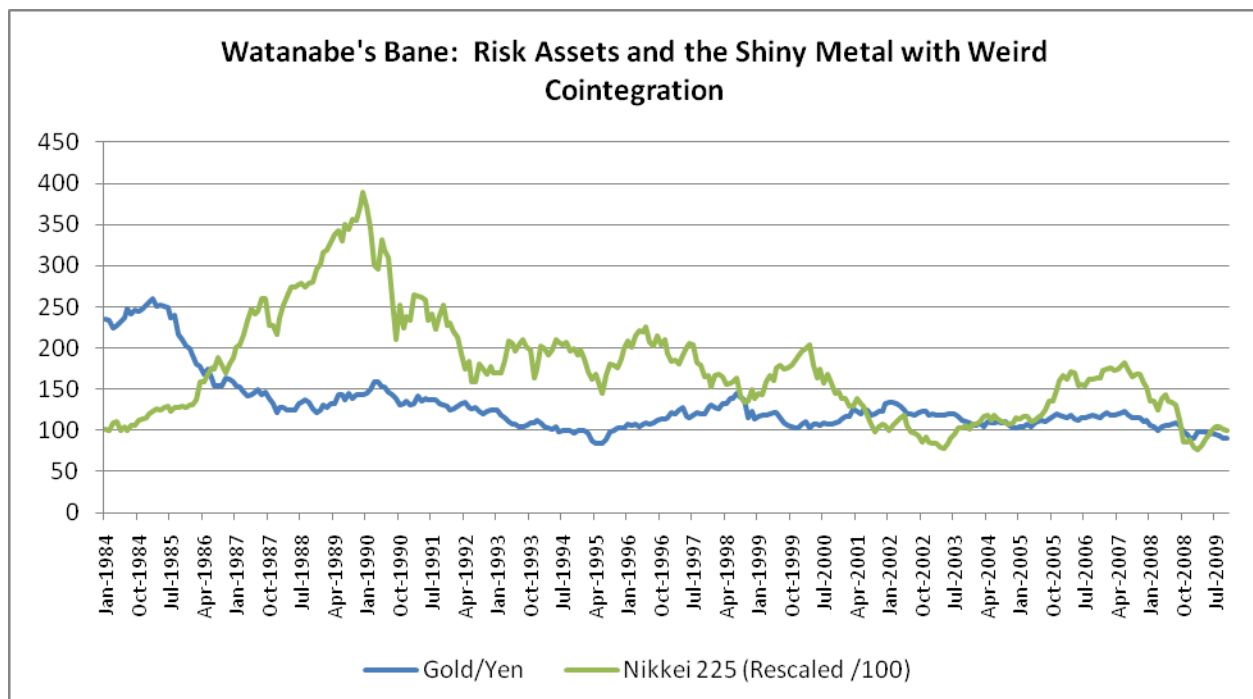
Printing money doesn't halt asset deflation for long

Money-printing won't halt deflation because printing enough money to actually reverse deleveraging is self-defeating. Printing money is a pure shot of inflationary Everclear. But the gains seen from an inflationary reduction in the downside to hold assets is more than offset by inflationary destruction of collateral needed to purchase the asset in the first place. The only cure for asset deflation (we're really talking RE and CRE) is organic recovery in demand. For this, you need economic growth and employment. For an economy in a financial crisis and high unemployment, demand for real estate won't recover until a severe enough drop in prices significantly reduces the downside risk of holding property. Artificial attempts to pump prices don't work.

Deleveraging is a vicious cycle downward that crushes asset prices in almost-periodic waves

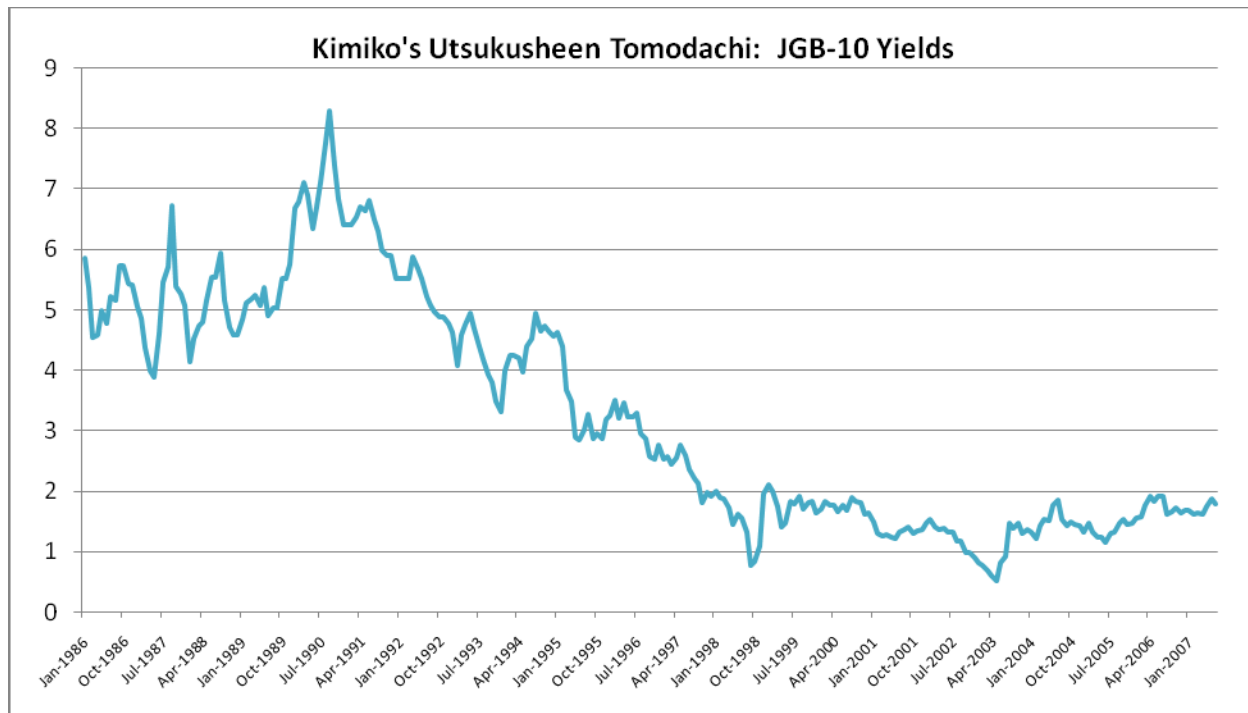
Companies and people get hit when falling prices (labor compensation or revenue) make them unable to service their existing debt obligations and so force default or liquidation of assets. These defaults and liquidations reinforce deflation and credit contraction in ever greater waves. These contractions do not happen in a gradual fashion... they happen in sudden bursts of volatility. This volatility is the chiefly the domain of equities and some commodities. I have risk exposure myself. Remember that nimble timing and ample leverage sound easy, but are they not.

As for those who love gold: I understand you. Anybody that has held a gold coin in their hand feels the draw. Anybody who held GLD in 2008 knows how effortlessly poised she is in great crisis. It is with regret that I bash gold. Respectfully, I don't think you understand gold, bugs. When things are at their worst, she is lively, wise, and beautiful. But things never remain in great crisis. Nearly every intensity eases into mediocrity. In times of mediocrity gold doesn't give anything to the relationship. She's only happy when it rains. Gold isn't a good risk asset for those inclined to surf liquidity, either: pretty crappy wave most of the time. More on this further down.



Deflation safety is not found in owning high priced things, rather in *highly credible* promises of future income

Why do you think PIMCO has so much U.S. paper and so little HY allocation? It's because Bill understands deleveraging. He probably knows very well Japan's decade+ performer, aka, Kimiko's very special friend.



If you think that the bull market in U.S. Treasuries is at a top right now, well I really can't blame you. I respectfully disagree in spite of the irresponsible issuance coming on deck, simply because conditions are really that bad in my view. Notice that *yields were less than 1% for 10 year Japanese government bonds in spite of exploding debt/GDP ratios!* Also, quantitative easing (money printing) didn't drive yields down more... it only created an extended and what will ultimately be an unsustainable top. It is the crushing effect of insolvency further down the capital structure that bids govvie bond prices up. I submit that Treasuries haven't seen the top yet.

Expenses < = revenues ends Japanification

Governments are the final domino. Government finances deteriorate due to fiscal spending during the crisis and a decrease in tax revenues amid the economic downturn. There is no choice: governments must triage the basket-cases, rationally distribute the pain, and firewall off the essential financial structures that can be saved; or the market does same with a colder, more merciless precision.

Lao-tzu has an answer for Aristotle. Don't defeat the irresistible object by being immovable against it: yield to it. All the Dao of heaven wants is for things to return to reality and exist within their means. Fighting what can't be beaten only makes the end bloodier. My view is that the Fed will not win their battle to reverse deleveraging. This does not mean the world will look like a woodcut from Gallerie St. Etienne. Frankly, excepting Wall Street and the financial world, there's not much loss for the U.S. Do what you can Ben. Nothing escapes the Dao.

For discerning palates... least squares

I was curious about how gold will perform in the future. To do it, I took a lesser traveled road via the Japanese experience. I did find that its lack of correlation (and cointegration) to the Nikkei and JGBs over any theorized horizons could actually make it desirable as risk minimizing seasoning in some kinds of post-bubble soufflés.

This may not be the venue to discuss my Stock-Watson difference filtration, but a linear regression never hurt anybody. I'm happy to share the whole megillah instead of just this dry heave, if desired. Always glad to puke number-crunching at fellow seekers. Here's what I found.

- Before the Japanese equity bubble burst, the gold price was positively correlated with rising yields. In other words, it acted like a good inflation hedge. Significance is good enough (Pr > t: .046), the slope estimate shows a lively response, and I won't complain about the R² (0.521).
- Post-bubble, gold loses its luster. With no inflation, the correlation to rising or falling bond yields broke down. There's no significance at the 5% level, and the parameter estimate is skunky anyway. The whole model fit sucks (R² 0.137). For this time interval, gold remains mysterious, and further research (cointegration) says it doesn't make a good pair trade.
- Over the whole time series (or the intervals I assigned) gold is never a good risk asset. You want risk exposure? Long equities or something else.

So... model: $(\text{Spot Gold in Yen}_t) = \alpha + \beta_1(\text{Nikkei225}_t) + \beta_2(\text{Jap10s}_t) + \epsilon_t$

Analysis of Variance and Model Parameters: 1986-2009							
Source	F Value	Pr > F	R-Square		Variable	Parameter Estimate	Pr > t
Model	41.59	<.0001	0.2452		Jap10s	4.82641	<.0001
					Nikkei225	-0.00012691	0.5746

Analysis of Variance and Model Parameters: Pre-Bubble, 1986- December 1989							
Source	F Value	Pr > F	R-Square		Label	Parameter Estimate	Pr > t
Model	23.93	<.0001	0.521		Jap10s	6.72937	0.046
					Nikkei225	-0.00175	<.0001

Analysis of Variance and Model Parameters: Post-Bubble, January 1990-2007							
Source	F Value	Pr > F	R-Square		Label	Parameter Estimate	Pr > t
Model	16.72	<.0001	0.1379		Jap10s	1.38159	0.0755
					Nikkei225	0.00049301	0.0677