

Reflections®



About this Newsletter

Reflections is a monthly publication written by John Gilbert, CIO, GR-NEAM. Each issue focuses on current capital markets and investment topics. Our clients find it somewhat unique from many investment publications typically received.

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History Ignored, Again

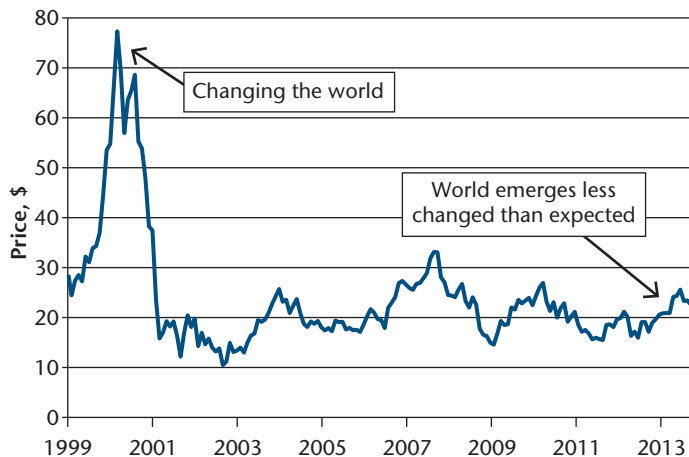
It would seem fair if Twitter were to share. The company's initial public offering was a staggering success, of course. Priced at \$26, the stock closed its first day of trading at \$45 per share. The company was thus endowed with a market capitalization of \$25 billion. The company has no earnings, but who cares. Adding back non-cash charges to produce earnings before interest, taxes, depreciation and amortization, then adding back the financial value of non-cash employee compensation, the company can be regarded as profitable. Such a number for 2013 may approximate \$50 million or so. The company is valued at 500 times such results, which exclude expenses that do have economic value. Correctly accounted, the company makes not a dime. But who cares when circumspection is the investment equivalent of tuberculosis.

It should be obvious to everybody by now that such stock market largesse is made in Washington. The specific address is the Eccles Building on Constitution Avenue, home of the Federal Reserve. In fact as citizens and U.S. taxpayers, we think it would be an expression of gratitude if Twitter were to take a little pressure off of the Fed and buy some Treasury bonds themselves. But that is not our remit, the company would reply. We are here to, well, Twitter.

Happily, not all members of the U.S. government are as pleased as the central bank to induce investors to behave foolishly. On the eve of Twitter's IPO, Mary Jo White, chair of the Securities and Exchange Commission, offered cautionary remarks on investing in complex or inchoate technology businesses. The stock market ignored her, but her comments were well chosen.

We have seen this all before and it ends badly. Ms. White's remarks were presumably pollinated by the lessons of history. By coincidence, in the same week that Twitter completed its offering, another tech firm reported disappointing earnings. That firm was Cisco, which was one of the belles of the stock market boom of the late 1990s. By the peak in early 2000, Cisco was valued at about \$500 billion, which was 200 times the company's then earnings. An impressive valuation, also. But back then, Cisco and brethren were going to change the world. Sort of like Twitter today. Chart 1 is Cisco, tracing out the dreaded where-the-Rocky-Mountains-meet-the-Great-Plains stock price pattern.

Chart 1. Cisco



Sources: Bloomberg L.P. and GR-NEAM

Cisco's valuation has been decimated, and it trades today at only about 11 times earnings, a rather modest valuation, and a reminder that following such a crowd is an excellent hedge against ever being financially independent. Gravity wins in time.

Cisco's discouraging recent earnings disclosure was particularly ironic, coming as it did in the week that Twitter led the Fed-driven market upward. That is because the company made pointed comments about a sudden deceleration in their businesses in many emerging market

economies in the last few months. This is not only a cautionary tale about the uncertainty implicit in technology businesses. We fear that it may precede more such news from a number of firms and emerging countries that have benefitted from the same central bank policies of which Twitter is the lottery winner of the moment.

We applauded Fed Governor Jeremy Stein when, in his paper of February of this year, he broached the subject of unintended consequences of the Fed's unconventional policies. We have long held that view. Governor Stein explored a number of evident candidates, including mortgage REITs and high yield bond issuance. One asset class that he did not discuss was emerging market debt issuance, which to us seemed then, and since, as even more important because of its systemic nature. Emerging market borrowers can borrow at very low rates in dollars, and have accepted the opportunity with alacrity.

When Chairman Bernanke broached the subject of reducing bond purchases back in February, long-term rates began a sharp rise that took the yield on the 10-year Treasury from 1.6% to 2.5% to 3.0%, where they remain. While such yields are low by historic standards, the change at the margin is significant. It has already retarded activity in the U.S. mortgage market, for example.

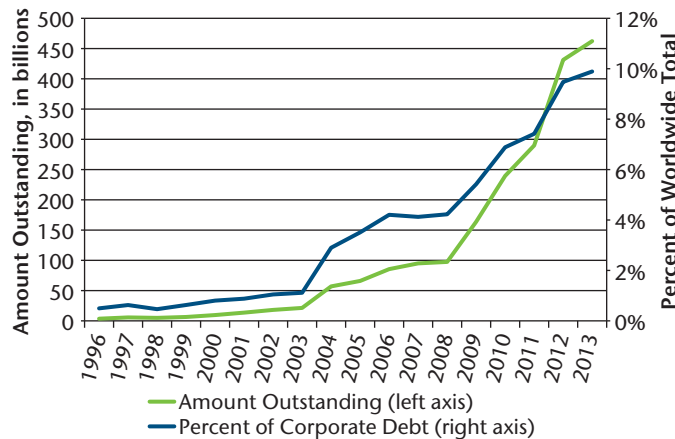
The most important emerging market borrowers have historically been sovereign governments, who could reduce their borrowing costs so long as the currency mismatch did not move against them. From time to time, it did, resulting in such borrowing being referred to pejoratively as original sin in international finance. But at least those were sovereign governments.

An alarming feature as the current credit cycle has developed has been the rapid growth in borrowing by emerging market businesses. Many emerging countries have had boom conditions over most of the period since the Asian Financial Crisis. China's accession to the WTO in 2001 was followed by a massive investment program that provided a massive and rapidly growing market for the exports of many other emerging nations—and the businesses that produced the coal, steel, copper and cement China required. The Lehman bankruptcy was an abrupt interruption of the boom, but China's response was a redoubling of investment to overcome the financial crisis. So China's demand for imports surged again, much of which was satisfied by emerging market vendors from Brazil to Indonesia to Africa.

Those boom conditions coincided with the Fed's everyday low price interest rate policy. The temptation to borrow in dollars at low rates, and take the chance on exchange rates, was evidently too powerful for many corporate borrowers. In fact, at the time, the currencies were moving in their favor. Booming exports made for resilience, or even strength, in their currencies against the dollar. Borrowing in dollars seemed to make all the sense in the world.

The result was a boom in borrowing to match the boom in business. Chart 2 shows the increase in dollar—denominated borrowing by corporations since the Asian Financial Crisis in 1997–1998. It has exploded since the Federal Reserve has suppressed borrowing costs in the last five years.

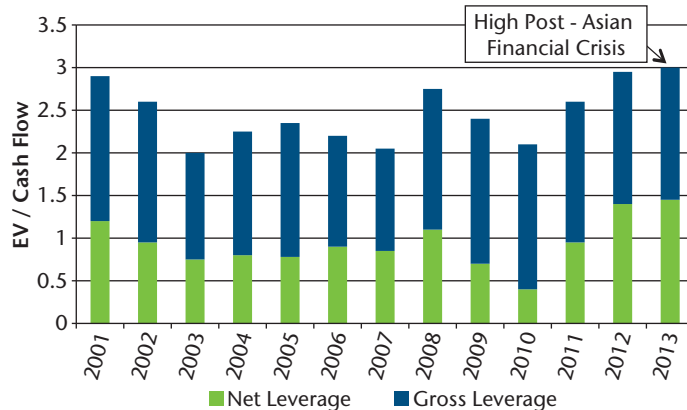
Chart 2. Emerging Markets' Share of Corporate Debt Outstanding



Sources: Bank of America Merrill Lynch and GR-NEAM

The result of this roaring issuance is that debt ratios have risen to a level not seen since the Asian Financial Crisis of 1997–1998, as shown in Chart 3.

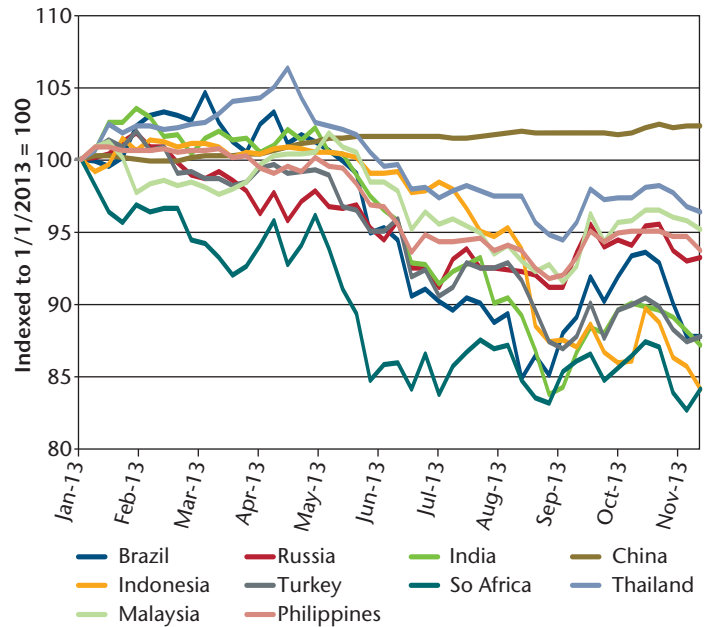
Chart 3. Asia (ex- Japan) Corporate Leverage



Sources: Morgan Stanley and GR-NEAM

This might be disquieting, but not necessarily troublesome, if the currency mismatch were not an issue. But shortly after Bernanke's suggestion in May that the punchbowl might be removed, capital began flowing out of the hot emerging markets. The result was downward pressure on their currencies, which in some cases is severe. Chart 4 shows the change in exchange values versus the dollar for a number of affected emerging countries.

Chart 4. Emerging Market Currencies



Sources: Bloomberg L.P. and GR-NEAM

The systemic nature of the problem—booming debt issuance in dollars, followed by contemporaneous currency shocks in response to Bernanke's comments in May—coincides with the sudden slowing in demand for Cisco's equipment and, perhaps, others as well.

This is a major component of the downside to the Fed's program. They have created a systemic risk in the world financial system for which they take little or no responsibility, because that which happens outside the U.S. is not their assignment. But as custodians of the reserve currency, it ends up that way.

We may be seeing the leading edge of a wave of credit problems among corporate borrowers in emerging market economies. Let one think it does not affect the U.S. and other developed market countries, recall the Asian crisis chronology. Thailand devalued its currency in the summer of 1997 and few outside of Thailand cared. But contracting Asian demand reduced demand for oil, and Russia (whose exports are 80% oil) defaulted in August of 1998. Risk spreads widened, and five weeks later, Long Term Capital Management was insolvent. That was a systemic event and caused disruption in markets in general, and a stock market decline. So for those who believe that they are protected from loss by central bank behavior, a little history is in order. As usual. Particularly for Twitter aficionados.



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