



# THE PAIN REPORT

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## Climbing the Mother of all Walls

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I have become mesmerised by the massive triple top in the S&P 500 that you see below.



From mid November I have urged you to stay the course and buy equities and sell bonds. At the time of writing, however, it looks like we are about to witness the most significant setback since that time.

As with every correction, there is a confluence of factors that could see the market move lower. On the technical front, and in the spirit of a picture paints a thousand words, it is right in front of you. The S&P 500 made a new closing high on Tuesday, at 1570.25, which is just points away from its all time intra-day high of 1576.09 set in October 2007.

For those of you who couldn't give two figs about the short term direction of the S&P 500, and are more interested in the medium to long term performance of the market and the global economy, you can turn off your bed side lamp and go straight to sleep!

Over the last few months the markets have had much to worry about, some of which I covered in my last report, 'Climbing a Wall of Worry', but since then we have had the tragedy in Cyprus and its possible spill over into the eurozone and now, more recently, events in North Korea.

Let's deal with Kim Jong Un first and say, up front, that if he did not have nuclear weapons no one would even know his name. Unfortunately he does. The other problem is that we really don't know a lot about him and what we do know is that he is 30 years old and seemingly keen to impress his military establishment that he has got what it takes, whatever that is. What we also know is that the Chinese, given they supply North Korea with most of its fuel and food, are the only nation that can talk to them. What is also becoming clearer by the day is that China is increasingly embarrassed by the 'look at me' behaviour of the North Korean leader. This is surely the very last thing that Xi Jinping wants to deal with so soon after assuming office. Unfortunately, we also have newly elected leaders in South Korea and Japan, both of whom are keen to demonstrate that they too cannot be pushed around. None of this is good.

Over many years now, we have all learned to ignore the antics of the North Korean leadership and have largely dismissed them as irrelevant in the larger scheme of things. For decades what happened in Pyongyang had absolutely no bearing on anything of any consequence, and we ignored their interminable blustering.

I think this is about to change.

Briefly put, China has had enough and will make the situation go away. If they don't then we do have a serious problem. However, I just cannot see how the Chinese could conceivably want to see things escalate any further. Perhaps, and it's just a thought, the Chinese have allowed the situation to deteriorate so that they then could be seen to be the white knight riding to the rescue. Stranger things have happened, and, in the Machiavellian world of geopolitical posturing, this actually might make sense. If Beijing was seen to be resolving this issue once and for all, then it would most certainly herald the coronation of China as a major power on the global stage. In this regard, the last thing China wants is for America to have even more reasons to set up camp in its backyard. Indeed, the North Koreans are providing the Americans with plenty of reasons to accelerate the so-called 'Asia Pivot' and expand their military presence in the Pacific.

Whichever way I look at this, China has a strong motive to defuse the situation quickly and I believe that they will.

Is it not ironic that our main focus over the last several weeks has been on two countries which, combined, amount to hardly a rounding error, in terms of global GDP? I am less fearful today, than I was a few weeks ago, about the Cypriot situation and its potential to impact the rest of

the eurozone. I am not ruling out Cyprus eventually leaving the eurozone, but for the moment sense that the risk of contagion has been contained.

Moving away from Cyprus and North Korea, the issue we really need to think about is U.S monetary policy.

I remember February 4<sup>th</sup> 1994 very well indeed. That was the day the Federal Reserve 'unexpectedly' raised interest rates from 3% to 3.25%. Prior to that time, Alan Greenspan had maintained interest rates at extremely low levels, as the United States recovered from the S&L crisis and the recession of the early nineties. There was absolute carnage in the bond markets as no one on Wall Street had expected a rate hike so early in the year. In fact, virtually no one had the Fed raising rates until 1995.

Let's get straight to the point. I am increasingly uncomfortable with the view that the Fed will not increase rates until 2015.

As you know I am much more optimistic on the U.S economy than the consensus, with a forecast of 3% in 2013. Housing will be a key driver, delivering at least a 1% plus impact upon growth, combined with an improvement in consumer spending and business investment; all of this to be underwritten by an increase in bank lending, as we see traction between monetary policy and the real economy. Please see 'The Rubber Meets the Road' for a more detailed outline of my U.S economic outlook for 2013.

This leads me to believe that the Fed will be looking to raise interest rates long before 2015 and that prior to an increase in rates it will reduce its monthly purchases of \$85 billion in Treasury and mortgage debt. In fact the Fed, in my view, is likely to start telegraphing such a change in policy over the next couple of months so as to carefully manage market expectations, being ever mindful of the bond market crash of 1994. This time around, however, the bond bubble is of epic proportions and deflating it slowly, rather than popping it, will demand some quite extraordinary management by the Fed. No wonder Ben Bernanke looks likely to retire in January next year!

My stronger than consensus view on the U.S economy, and my belief that we will reach the all important unemployment rate of 6.5% sooner than most anticipate, suggests that the debate about Bernanke's exit strategy is now going to be the number one issue for investors in the months ahead. In short, and to state the obvious, the stronger the economy, the quicker the exit from quantitative easing.

My belief is that the U.S economy is now strong enough to be slowly weaned off its diet of QE, but the pathway to the normalisation of monetary policy is going to be one fraught with many potential pitfalls and markets, as we all know, hate uncertainty.

In my last report, I said how impressed I was in the market's ability to climb the proverbial wall of worry and this suggested to me that we could move higher. Today, I am more cautious as we brace ourselves for a reversal in U.S monetary policy. The U.S market has had a very strong rally, since the mid-November low, and it's time to pause for breath be-

fore we make the final assault on the triple top, which we will do in the months ahead.

In recent months, I have written about the prospect of the Bank of Japan pursuing a turbo-charged monetary policy so as to ensure that they escape the deflationary trap. Yesterday the newly appointed governor of the BOJ, Haruhiko Kuroda, most certainly delivered on his promise with the announcement that the central bank will aim to double the monetary base over two years, through the aggressive purchase of long-term bonds. This is a game-changer for Japan and I continue to see the Japanese currency heading to \$/Yen 100, and higher, and for an improvement in the Japanese economy.

As the third largest economy in the world ramps up QE, the world's biggest economy will wind down theirs.

The global economy is now on a much stronger footing and monetary policy continues to gain traction, with the notable exception of Southern Europe. The heavy lifting is being done by the Americas, Africa and Asia and by the time tired old Europe recovers Bernanke will have made his exit and Janet Yellen will be burdened with the most complex juggling act in monetary policy history.

We have some interesting times ahead.

All the very best,



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# THE PAIN REPORT

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## Stay Positive

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Those of you who spend a lot of time in airports will not be surprised by the latest Skytrax survey of the world's best. Singapore came in at number one, followed by Incheon in South Korea. In fact, Asian airports once again dominated the top 10. And when it comes to airlines, no one comes close to the Asian and Middle Eastern carriers.

I remember my first trips to Asia in the eighties, and how impressed I was, then my first experiences of American airports, and how distressed I was, and they have got even worse since.

I have long believed that airports and airlines tell one a lot about the world.

In Saudi Arabia I had my passport thrown at me by a 'charming' customs official as he screamed abuse. As I walked away I asked my Egyptian colleague what on earth he was so upset about. It is too embarrassing, he said. After some pestering, I found out that the customs official was horrified that a Christian had been granted a visa by the Islamic Development Bank.

In Khartoum I was asked by an official- looking chap to make a donation to the modernisation of the airport, as he held out a brown cardboard box. When I gave him some Sudanese pounds he said, they only take American dollars. Shortly after giving him the money, in his desired denomination, I nearly stepped into a gaping hole in the middle of the concourse.

On my first trip to Bermuda I was asked, when presenting my passport, if this was my first time in Bermuda. When I said it was, he proceeded to say welcome to Bermuda about five times, with a wonderfully radiant smile. I could go on and on, but suffice to say those first experiences pretty much summed up the above three countries. In fact, some of my other airport experiences in Saudi cannot be told in these pages.

A long time ago I could see and feel that the world was changing dramatically.

When I first arrived in Australia, in 1997, I was stunned to find that no one was talking about China. In 2002 I gave a speech entitled 'A Sleeping Giant Awakes' and then in 2005 a series of speeches called 'The Mother of all Crossroads' which was my attempt to talk about the problems ahead for America, but also the extraordinary promise and potential of Asia, and China in particular.

A leading Chief Economist who heard the speech at the time remarked to me, "catchy title but personally don't believe a word of it."

Today, as we all know, China is at the centre of everything, particularly for us in Australia. But China is now witnessing massive change. Just as China changed the world, it is now experiencing massive internal change which we need to pay close attention to.

I have remarked, previously, that I increasingly like the look of China's new leadership. I am convinced that the new president and premier are reformists at heart, but, as always, will have to pay lip service to the more conservative factions in the ranks of the communist party, as they liberalise and reform the world's most populous nation.

In the meanwhile, the great rebalancing continues and the Chinese consumer is going to spend more and save less. Many in the west, in my view, still under-estimate this seismic shift in spending habits. As I have said so many times, the most significant and defining economic phenomenon of our life time, and possibly any time, is the rise of the Asian middle classes.

It is so important, however, for us to understand that the consequences of this historic event are not just economic but are also socio-economic and cultural.

As incomes rise across Asia, the world's airports and aeroplanes will become filled with hundreds and hundreds of millions of people who will be taking their first trip abroad. Stomachs will be filled with more meat and dairy products as dietary habits change. Many millions will travel abroad for education. The world will become much more united as globalisation moves into a higher gear and delivers so much more than just economic integration. As Karl Marx once said, "The mode of production of material life conditions the social, political and intellectual life process in general."

He would no doubt be turning in his grave to find that, in fact, the free market was the 'mode of production' that has raised billions out of poverty.

It is not, however, just a story about the middle classes in Asia, but in Africa and South America too. Indeed, nationality, colour and gender are becoming irrelevant as we become ideologically more united and better educated. Technology has brought us all closer together and the information playing field is now much more level. The digital age gives us a greater degree of transparency and connectivity, which in turn lifts our potential productivity.

All of the above makes me strongly believe that the decades ahead will see an era of prosperity, enlightenment and opportunity that very few are predicting.

In recent years I have spoken regularly about my optimism for Indonesia, and the extract below from a McKinsey Global Institute research paper, 'The archipelago economy: Unleashing Indonesia's potential,' sums it up pretty well.

"Indonesia's economy has enormous promise. Already the 16<sup>th</sup>-largest economy in the world, this dynamic archipelago has the potential to be the seventh biggest by 2030. It is a much more stable and diversified economy than many outside observers assume. In recent years, Indonesia has made enormous strides in its macroeconomic management. Inflation has fallen from double into single figures, and government debt as a share of GDP is now lower than in the vast majority of advanced economies. The economy, part of a resurgent Asia, is transforming rapidly. Indonesia has a young population and is quickly urbanising, powering growth in incomes. Between now and 2020, Indonesia will be home to an estimated 90 million additional consumers with considerable spending power. This growth in Indonesia's consuming class is stronger than in any economy of the world apart from China and India, a signal to international businesses and investors of considerable new opportunities."

In the same report, the following commentary also caught my eye.

"The global consuming class will increase its membership by 1.8 billion members over the next 15 years, of whom more than 75 percent are likely to be in Asia. The economic transformation in India and China is happening at a scale and pace unprecedented in history. Average incomes are growing at ten times the pace and on more than 200 times the scale of their increase during England's In-

dustrial Revolution." (Consuming class being defined as individuals with an annual net income of above \$3,600 at 2005 purchasing power parity.)

I urge you to read the whole report, and not just because it supports my view but because it will make a welcome break from the overwhelmingly negative and jaundiced commentary in much of the western media, as it relates to Indonesia. In this regard, and I cannot resist it, when was the last time you saw a positive story in an Australian newspaper about our nearest neighbour with a population of 240 million people?

It is worth noting that, since 2008, the Indonesian stock market has been one of the best performing equity markets in the world, rising over 300%.

Through the latter part of last year I became much more positive on the Japanese economy and stock market, and similarly developed a much stronger than consensus view on the U.S economy. These views remain unchanged.

The American economy grew 2.5% in the first quarter, which was less than the consensus forecast of 3%. The second quarter is likely to be quite a bit weaker, but then I see a significant improvement in the second half of the year. In truth, my full year forecast of 3%, which incidentally is one of the highest in the market, will be tough to achieve, but once I make a forecast I don't change it each month, unlike my friends on Wall Street.

The numbers on the housing front, in terms of sales, construction and prices, continue to be very impressive and coupled with a strong recovery in auto sales will support growth over the remainder of the year. I think the positive wealth effect from a rise in stock and house prices is still being under-estimated and this combined with an improvement in the manufacturing sector and the ongoing energy revolution will see a much stronger than consensus performance by the American economy.

There was much dismay in global markets when China released its first quarter GDP, which saw growth of *only* 7.7%.

Such a reaction no longer surprises me, but, given the government is forecasting 7.5% for the year, we need to get used to numbers with a 7 in front of the decimal point.

The important point to highlight is that consumption's contribution to growth, once again, exceeded that of investment, which highlights that the great re-balancing continues.

The new leadership team in Beijing has many challenges ahead of it as they continue to stress the quality of growth over the quantum of growth. In this regard the shocking levels of air pollution in cities such as Beijing must be noted. According to The Economist magazine, China has seen more than a fivefold jump in mortality rates for lung cancer over the last 30 years. The article suggests that air pollution is by far and away the major culprit, as smoking rates have not changed materially over the survey period.

Such an alarming report vividly and painfully illustrates the price that has been paid for the industrialisation and motorisation of the world's most populous nation. No doubt it is air

pollution and corruption which occupy the minds of China's leaders much more than the truculent maverick in Pyongyang.

In recent months, attention has returned to the issue of the large amounts of local government debt. For those who, over the years, have been mega-bears on China, this, coupled with the growth in the shadow banking system, is the 'I told you so' subject of choice. In fact a quick Google search on both subjects will unleash a torrent of terrifying headlines.

I do not intend to add to the already comprehensive coverage on this subject, other than to say please refer to my report, 'The Chongqing Express', which I published in April 2010.

Both these issues are a problem, but in my view are manageable. Indeed, I downgraded my long term forecast for Chinese growth to 7%, back in 2010, largely driven by my view then, that such borrowing by local governments was unsustainable.

Turning now to financial markets, at the close on Friday 3 May, we saw new highs in the S&P 500 and the Dow Jones, following an impressive U.S employment report for April and some significant upward revisions to the months of February and March. Average monthly jobs growth for the last 3 months has been a very solid 212,000.

In last month's report I suggested we were likely to see a short term correction, as we prepared ourselves for an assault on the record highs. We did see a brief correction, but it was much smaller than I had anticipated. Hopefully, you kept your eyes on the bigger and more positive picture that I have been depicting in my reports and took the advice, which I highlight below, from the April report.

*"For those of you who couldn't give two figs about the short term direction of the S&P 500, and are more interested in the medium term to long term performance of the market and the global economy, you can turn off your bed side lamp and go straight to sleep."*

As the saying goes, 'the trend is your friend' and the trend is for higher stock prices, not just in America but all around the world as investors begin to appreciate that the global economy is exactly that, global, and not just about Greece, Cyprus or North Korea-all of whom combined are a rounding error in terms of global GDP. Yes, I grant you that events in Italy and Spain are of much greater significance, but even here I see signs of improvement into next year. Anyway, I have moved on from writing and talking about the pain in Spain, which I did in 2010 and before, and I suggest you do too.

Beware the prism through which you view the world and be aware that we are witnessing profound changes, most of which are positive, in the world's most populous nations.

In this regard, I found it particularly ironic that the day the EU announced its 10 billion euro bailout of Cyprus, the Chinese announced plans to build a 10 billion dollar port in Tanzania. The former was the breaking news headline

across the western world whilst the latter did not get a mention.

Africa, the birthplace of humanity and with the world's most youthful population, home to one billion people, is witnessing a seismic transformation, both political and economic, which is great news for all its people and the broader global community.

In 2009, I first spoke of my view that we faced a new reality: that the world was increasingly divided between those nations that were submerging and those that were emerging. In some ways this could be seen as being overly simplistic, but it was my way of highlighting that certain nations had simply accumulated too much debt and faced a more frugal future. In recent times, given my more positive views on the two largest so-called submerging countries, the U.S and Japan, people have asked me if I am not thinking of removing America, at least, from the list. Not yet is my answer, as they still face some serious obstacles in the longer term.

What we shouldn't forget, however, is that less than 10% of the world lives in the so-called submerging nations, which means 90% do not. Given I have a much more positive view now on both Japan and America, and that in the longer term, I remain positive on Africa, Asia and Latin America, this leads me to forecast that we are about to see the most positive decade of global growth in more than 30 years.

Stay positive.

All the very best,

*Jonathan Pain*



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