



August 2010 Longview Letter No 48

The 'Old Normal' *a.k.a. Secular Western Bear Market Ongoing, the Decade of Turbulence*

Prepared for clients of Longview Economics

"...Critically all these cycles point, with differing degrees of accuracy, to this current decade as a crisis decade for the west and western equities..."

"...While this list is by no means exhaustive it illustrates a backdrop of overstretched economies which have become increasingly vulnerable to shocks and as such unlikely to deliver sustained multi year robust economic expansions..."

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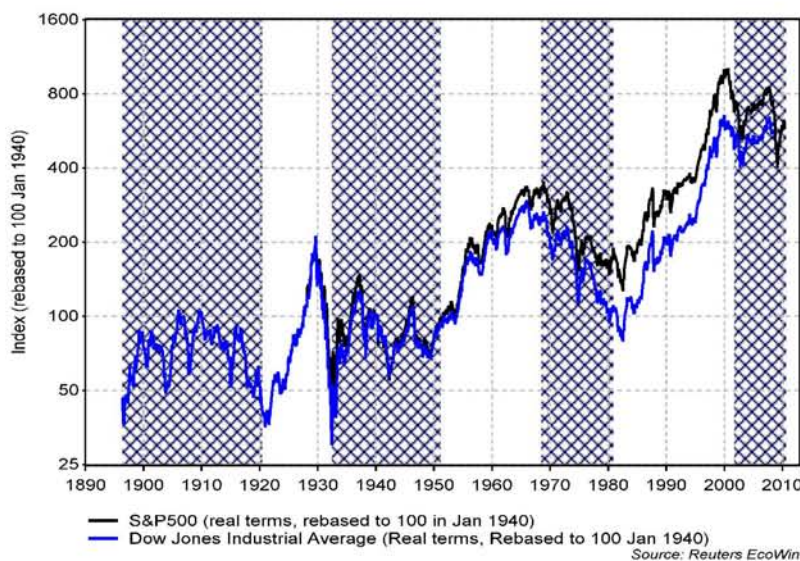


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 a.k.a. Secular Western Bear Market Ongoing, the Decade of Turbulence
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Overview

Western equities remain in a secular bear market. As such, while we expect this cyclical bull market to persist for 2 to 3 years longer, the outlook for western equities, beyond that timeframe, is poor for three key reasons: i) there is a confluence of a number of long term cycles, all suggesting that, at this current time, the west is entering or has recently entered a crisis period – historically during crisis periods western equities have been in secular bear markets. Typically these crisis periods last between 2 and 3 decades. At best we are currently halfway through a crisis period (see section 1); ii) the background structural macro economic environment is troubling – record high western indebtedness levels, deleveraging, poor demographics, money creation and risks of sovereign debt crises in the west create a harrowing environment for long term economic growth (section 2); and iii) valuations, which during the global financial crisis, never reached secular low levels from which secular bull markets typically begin (mirroring that, excess wasn't properly purged from the economy). With the rally from the March 2009 lows, those valuations are now significantly above long term average levels (suggesting that the valuation peak from 2000 should continue to unwind) – see conclusion.

Fig 1: US equity indices (real terms) shown with Commodity super cycles (shaded areas)



Over the last 115 years secular western equity bear markets have occurred during commodity super cycles (shown as shaded areas).

 Typically those commodity super cycles last 20 – 25 years. Given that this current one started in 2001, that would suggest a continuation of this secular western equity bear market through to 2020 and perhaps beyond.

Important disclosures are included at the end of this report



Section 1: The Long waves – a.k.a The ‘Old Normal’

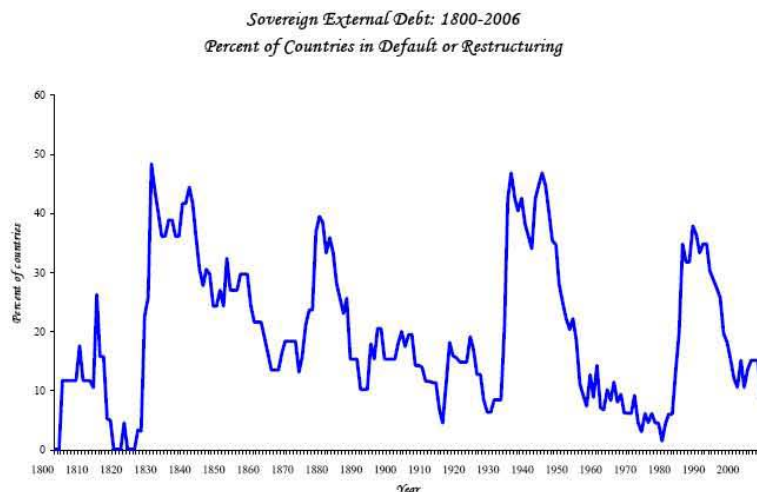
“Whatever is has already been,
and what will be has been before;”
Ecclesiastes 3 v 15, NIV

There is strong evidence for the existence of long cycles/long waves in both history and financial markets. These periods, typically lasting 20 – 30 years (at times longer), are characterised by distinct secular long term trends – whether leveraging or deleveraging; sovereign debt crises or strengthening government finances; times of peace or times of general war.

Sovereign debt crises, for example, are as old as the bond market. Rogoff & Reinhart in recent academic papers and their recent book “This Time is Different” show a 200 year history of cycles of sovereign debt crises (fig 1a). McKinseys, in their recent paper on “Debt & Deleveraging (Jan 2010), point to a number of incidences throughout history of multi year (even multi-decade) deleveraging cycles.*

Fig 1a: Sovereign debt crises – a history

Figure 1



Sources: Lindert and Morton (1989), Macdonald (2003), Purcell and Kaufman (1993), Reinhart, Rogoff, and Savastano (2003), Suter (1992), and Standard and Poor’s (various years).

Notes: Sample size includes all countries, out of a total of sixty six listed in Table 1, that were independent states in the given year.

Source: © Rogoff & Reinhart, This Time is Different, March 2008, NBER working paper no:13882

*Intriguingly 2 of the 3 US secular bull markets of the past 100 years have been accompanied by major leveraging up of the economy (i.e. 1920s secular bull & 1980s to 2000 secular bull – see fig 1) – only one did not involve significant increases in economy wide indebtedness (i.e. 1951 – 1968; post WWII baby boomers and rebuilding of US economy). Conversely the secular bear market, which then followed the secular bull of the 1920s was accompanied by long term deleveraging. It would also appear as though long term deleveraging is now underway in the west accompanying this secular bear (section 2).



Indeed many eminent economists and historians have found evidence of long multi decade cycles playing out over the last several hundred years. Kondratieff, for example, an eminent Russian economist, writing in the 1920s found evidence of a 20 – 25 year super cycle in commodities back to the 1780s which he believed permeated down into cycles in the economy (including periods of leveraging and deleveraging) and which we have subsequently demonstrated are coincident with secular bear markets in western equities (i.e. commodity super bull cycles = secular western equity bear cycles - see Longview Letter No 17 November 2007: "Commodity cycles, the K Wave and Long term trends in Equity Markets") – also see fig 1. Kindleberger writing in the 1990s found evidence of an approximate 100 year cycle in the economic primacy of the world – i.e. every 100 years or so a new global economic superpower emerges and takes over the mantle of world economic primacy from the prior incumbent (appendix 2). Arnold Toynbee, Research Professor of International History at the University of London, writing post WWII, found evidence of an "alternating rhythm" of a "Cycle of War and Peace". Punctuating this cycle were quarter century "general wars" that had occurred in Europe at roughly one century intervals since the Renaissance. Howe and Strauss, writing in 1997, also, like Toynbee, identify an 80-90 year cycle driven by the ebbing and flowing of a generational memory (appendix 3).

Critically all these cycles point, with differing degrees of accuracy, to this current decade as a crisis decade for the west and western equities. Kondratieff's latest commodity super cycle commenced in 2001 and as such, assuming history is a correct guide, should last until 2021/2026 (i.e. the average length of the super cycle is 20 – 25 years). Kindleberger, without precisely quantifying dates, found an approximate 100 year cycle of world economic primacy. The beginning of the end of that primacy is marked by 7 pre-conditions including financialisation of the economy, high levels of indebtedness, money printing and overseas energy dependency amongst others (see quarterly structural asset allocation No.1, November 2009: "Will the US\$ Reserve Currency Status persist?"). Today the US satisfies at least 6, if not 7, of those pre conditions – as such we are arguably in the decades of that handover of world economic primacy from the US to, perhaps, China/Asia. Historically, given that power is rarely surrendered willingly, these times of handover are often accompanied by significant global discord. Howe and Strauss, in their generational analysis written in 1997, identify 2005 as the probable start date for the Fourth Turning – i.e. the fourth generation which is the crisis phase of the 80-90 year cycle. The fourth phase is often accompanied by "remnants of the old social order disintegrating. Political and economic trust will implode. Real hardship will beset the land, with severe distress". In their view the crisis phase is likely to last until approximately 2025 (i.e. similar to Kondratieff). Finally Toynbee in his cycle of war reaches a similar, albeit more depressing, conclusion – i.e. that a global war is likely within the next 10 – 20 years.

If correct, the good news is that within a decade to 15/20 years, the west should emerge into a new secular bull market. The bad news unfortunately is the path that the west takes in order to reach that point is likely to be, at best, rocky and at worst meaningfully challenging. Given that, western equity markets, as per during prior commodity super cycles (and other crisis periods), should remain in a secular bear market.



Section 2: Possible macro & geopolitical challenges

An examination of history, as outlined above in section 1, suggests that a number of long cycles are all pointing to this current period in time (i.e. next 10 – 15 years) as a challenging 10-15 years for the west (and by implication also globally). On its own that is instructive. To complement that, though, it's informative to consider what possible causes might bring about the continuation of this crisis period and its associated secular bear market. Broadly these risks can be split into 2 categories; i) global macroeconomic challenges; and ii) geopolitical risks.

Section 2a: Global Macroeconomic Challenges

While shocks, by definition, are unexpected, there are at least 5 key groups of macroeconomic reasons why this crisis period/secular western bear market might persist.

A. Risk of Continued Western Sovereign Debt Crises

The case for Western sovereign debt crises persisting is well known and has been articulated by many (including ourselves – e.g. see Feb 2010 “Seven Trends for the Next Seven Years”). In that piece we outlined not only the current fiscal challenges associated with large structural fiscal deficits and high levels of indebtedness (as outlined by the IMF, most notably, in their November 2009 paper) but also the fiscal challenges associated with:

- i. ageing, and in some instances shrinking, western populations (plus Japan) – see appendix 1; &
- ii. large financial systems (often a multiple of GDP) which are too big to fail and as such have effectively become a government contingent liability for those countries (i.e. and thereby potentially rapidly and dramatically increasing their government debt to GDP ratios if another crisis occurs – see Longview Letter no 46, May 2010: “Financialisation, Gold & World Economic Primacy” for further analysis).

Amongst the advanced countries, potential candidates for a sovereign crisis include: **Belgium** (high debt to GDP; average structural adjustment required); **Italy** (high debt to GDP; small fiscal deficit, but low growth); **Japan** (high debt to GDP: large deficit; poor demographics; low growth); **the UK** (high deficit, large financial system although given recent fiscal consolidation plans as well as proposed changes to retirement ages, the UK's situation is improving); **Spain, Portugal & Greece** (see Longview Letter no 45: “Asian Crisis – Coming to Europe”, April 2010); amongst others. A crisis in one of those larger countries (e.g. Italy, the UK, Japan and Spain) would likely cause considerable market turbulence thereby contributing to a continuation of the current secular bear market.



B. US Sovereign Debt Crisis?

Over and above a sovereign crisis in those aforementioned European countries (as well as Japan), a more serious risk lies with a US sovereign debt crisis.

For now the US currency remains the reserve currency of the world economy with over 2/3rds of world trade transacted in US\$ and approx 65% of global central bank reserves held in that currency. This confers a special status upon the dollar and extends, beyond normal bounds, the ability of the US to keep borrowing from the rest of the world.

In order to maintain that ability to borrow beyond normal bounds, though, the US must retain global confidence in its ability to maintain its currency as a store of value. An undermining of that confidence could potentially spark a run out of dollar assets and into other up and coming proxy, or indeed emerging, safe havens (whether Remnibi, Bunds, SDRs, some commodity standard or some other new alternative). That could then become self sustaining with capital flight triggering a credit crunch and in turn, undermining the economy. At that juncture further QE from the Fed might further undermine confidence in the US\$ as a store of value and begin to generate a self feeding vicious circle.

Critical within this whole equation therefore are the possible factors which might contribute to an undermining of confidence in the US\$ as a store of value (including for example points 2c to 2e below).

C. US Budget Profligacy

On current projections the US government is running budget deficits out to 2020 (the CBO's forecast period) and then beyond. Those forecasts, however, assume i) that the Bush 2001 tax cuts are allowed to fully expire, which given current concerns about the economic recovery and current political discourse, is unlikely to occur; and ii) arguably over optimistic economic growth assumptions. As such the CBO's deficits forecasts are also probably too optimistic.

Table 1: Projected Deficits and Surpluses in CBO's Baseline (Billions of dollars)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Total: 2011-2020
On-Budget Deficit	-1,434	-1,076	-757	-659	-608	-619	-659	-659	-669	-765	-793	-7,263
Off-Budget Surplus ^a	86	96	108	120	133	139	138	134	127	116	107	1,216
Total Deficit	-1,349	-980	-650	-539	-475	-480	-521	-525	-542	-649	-687	-6,047
- Total Deficit	%	%	%	%	%	%	%	%	%	%	%	%
(% of GDP)	-9.2	-6.5	-4.1	-3.2	-2.7	-2.6	-2.7	-2.6	-2.6	-3.0	-3.0	-3.2
- Gvnmt Debt Held by the Public as a (% of GDP^b)	60.3	65.3	66.6	66.3	65.6	65.4	65.5	65.5	65.7	66.1	66.7	n.a.

Source: Congressional Budget Office

Note: GDP = gross domestic product, n.a. = not applicable.

a. Off-budget surpluses comprise surpluses in the Social Security trust funds as well as the net cash flow of the Postal Service.



Having said that though, under those probably over optimistic CBO projections, government debt is expected to increase by at least US\$7 trillion to approx US\$15 trillion by 2020. That equates to 67% of 2020's GDP (using the CBO's nominal GDP forecasts). In and of itself this is relatively benign. Critical within the assumptions though is the interest rate that is paid on the US government's debt. Currently 22% of outstanding government debt is bills (i.e. 1 – 12 month duration). A further 11% is 2 year debt and a further 9% is 3 year debt (see table 2 below). On current interest rate trends (e.g. with 2 year government yields, for example, recently making record new lows), **refinancing will result in a cheaper, not higher, interest bill over coming 1 – 4 years.** If interest rates return to normal levels, though, the interest rate bill could quickly become notably more significant. For example over the course of the next 10 years the **interest paid on Bills could increase ten fold** if the fed funds rate, gradually over that time frame, reverts back to 7% (NB this assumes increased bills issuance as well as continued roll of existing bills at higher rates. For the calculation we've assumed the proportion of new issuance each year allotted to bills remains at 22%).

Table 2: Outstanding US government debt – split by duration shown with current blended actual interest rate

Debt	Duration	Amount O/S US\$m	% of Total	Current blended interest rate	Debt	Duration	Amount O/S US\$m	% of Total	Current blended interest rate
Bills	1 - 12 month	1,782,526	22.03%	0.2%	TIPs	5 year	86,492	1.07%	3.4%
Notes	2 year	877,323	10.84%	1.3%		10 year	332,054	4.10%	3.9%
	3 year	721,063	8.91%	1.5%		20 year	81,264	1.00%	5.3%
	4 year	35,507	0.44%	2.1%		30 year	64,652	0.80%	5.3%
	5 year	1,613,221	19.94%	3.9%					
	7 year	623,757	7.71%	2.4%					
	10 year	1,067,462	13.19%	4.5%					
Bonds	30 year	806,806	9.97%	6.2%					

Source: US Treasury - TABLE III - DETAIL OF TREASURY SECURITIES OUTSTANDING, JUNE 30, 2010

For that to happen, though, either growth would exceed expectations – which would be a positive factor and a scenario in which deficits would shrink naturally – or the US would suffer an inflation shock. Whilst an inflation shock is plausible (especially if Eastern economies continue to boom), for now, especially given the background of the deleveraging dynamic, it looks unlikely. As such a Greek style spike in interest rates, because of concerns over the US's fiscal path, seems unlikely (for now).

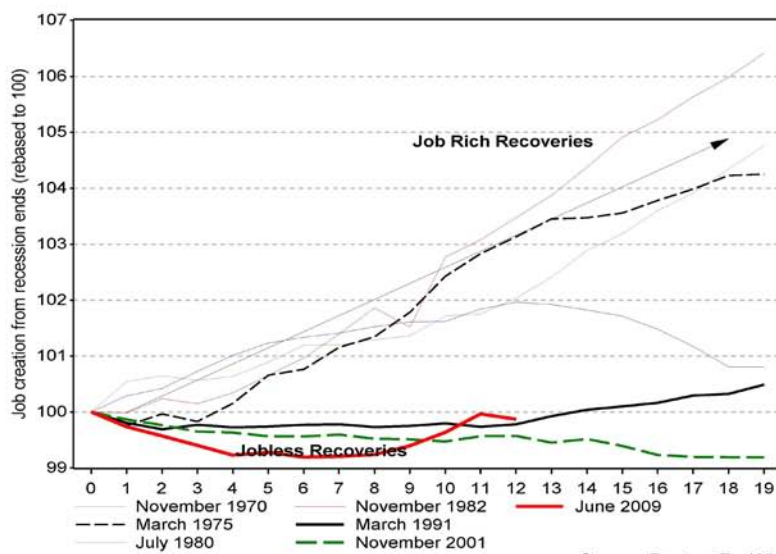
D. Continued Jobless/Tepid Recovery & Risks associated with more QE

A more realistic scenario is a continuation of a tepid recovery (as outlined by Rogoff and Reinhart in recent papers). That would mirror the typical recovery from a financial crisis (as well as mirroring the prior 2 recoveries). A tepid recovery, as in 2001 & 1990-91, would probably be a 'jobless recovery' with little employment growth. To date job creation in this recovery is running inline with the 2 recent jobless recoveries (fig 2). That may encourage significantly more QE (i.e. given deflationary pressures and weak employment growth). That itself,



especially if it's a recurring theme over a number of years, may undermine international confidence in the US\$ as a store of value thereby engendering a widespread dollar sell-off associated with a spike in interest rates.

Fig 2: US employment (rebased to 100 @ the start of economic recoveries)



Prior to the 1990s recession, job rich recoveries were the norm with job creation beginning as the economic recovery began. Since 1990, recoveries have been 'jobless'

NB the X axis = number of months from the start of each economic recovery

Source: Reuters EcoWin

Furthermore that eventuality is more likely if there's an emerging alternative to the US\$ as a global reserve currency. For now the choices are limited. As we outlined in Quarterly Asset Allocation no 1. November 2009, however, Chinese policy makers are increasingly introducing measures to encourage use of the renminbi in international transactions. As an example of a small part of that programme, last month, CITIC Bank International and the Industrial and Commercial Bank of China completed the first swap of Hong Kong dollars for RMB (see weekly China newsflow email for details). A number of other renminbi currency swap arrangements have been enacted with neighbouring countries to China these past 12 months (once again to encourage trade in RMB rather than US\$). More importantly the Chinese authorities understand that deep and liquid financial markets are critical to broad global acceptance of their currency. As such the Chinese authorities plan to continue to develop the bond market (sovereign and corporate) as well as eventually more fully open the capital account. These measures, naturally, take time. Few other potential long term alternatives to the US\$ currently exist, although the Chinese amongst others are pushing the IMF's SDR as a future possible option.



E. Persistent De-leveraging

Another factor which may contribute to further US QE (and further undermining of confidence in the US\$) is continued de-leveraging of the US economy and financial sector. Clearly the level of private (and public) sector indebtedness is unprecedented (either in peace or war time) – fig 3. Total US debt to GDP peaked at 376% of GDP in q1 2009. Since that time it's fallen to 360% driven primarily by deleveraging in the financial sector. Total US financial sector indebtedness has fallen from 121% of GDP (q1 2009) to 103% on latest data (q1 2010) – fig 4. Amongst that total, indebtedness of ABS issuers has fallen most markedly from US\$4.5 trillion (i.e. 32% of GDP) to US\$2.8 trillion currently (i.e. 19% of GDP) – fig 5. Other financial sub sectors have also been deleveraging including: i) agency, GSE & federally mortgaged backed securities; ii) finance companies (from US\$1.3 trillion q1 2008 to US\$1.0 trillion q1 2010); iii) funding corporations (US\$1.25 trillion q4 2008 to US\$790 billion in q1 2010); as well as on a smaller scale iv) REITs, savings institutions & broker dealers. **The flip side of financial sector deleveraging is pressure on financial companies to reduce the asset side of their balance sheet (unless they can replace the debt with another source of funds, e.g. with deposits). Shrinking financial sector assets should therefore place pressure on banks and financial institutions to curtail credit. Reduced consumer credit (and availability of corporate sector credit) reduces the ability of the economy to grow.** Increased credit card borrowing typically = increased economic demand (unless it's replacing other debt). As such accompanying the deleveraging in the US financial sector there is also a continued contraction in the amount of outstanding consumer credit (fig 7) and home equity loans (fig 8) while, over and above that, small businesses in the US continue to find it challenging to access credit (fig 9). If these trends continue then, given their implications for economic growth, they raise the possibility of further significant QE (as the Fed seeks to counter deflationary deleveraging forces and high unemployment).

Fig 3: Total US debt (incl. financial sector debt) as a % of GDP – (nb data annual not 1/4ly)

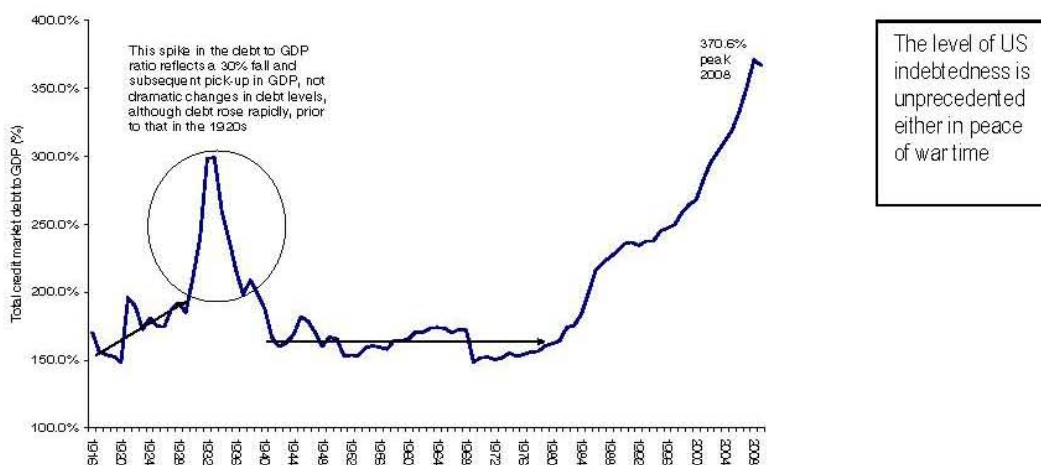
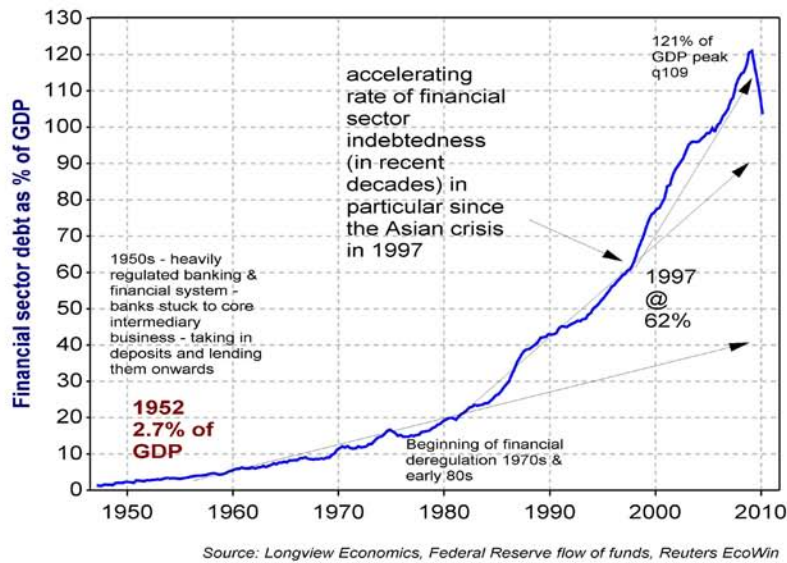


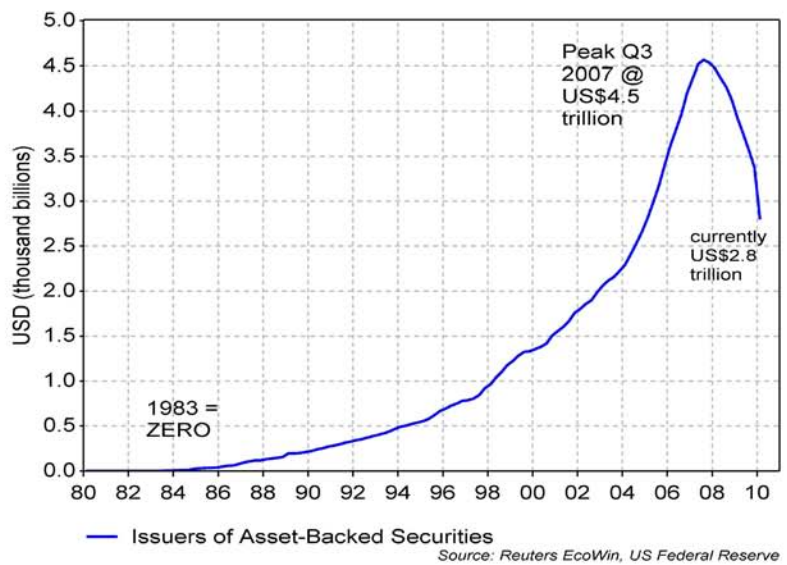


Fig 4: Total US financial sector debt as a % of GDP: 1947 - 2010



With the financialisation of the US economy, total financial sector debt grew from around 10% of GDP in 1970 up to 121% of GDP by its peak in 2009

Fig 5: Total US financial sector debt: asset backed securities vehicles outstanding debt (US\$tr)

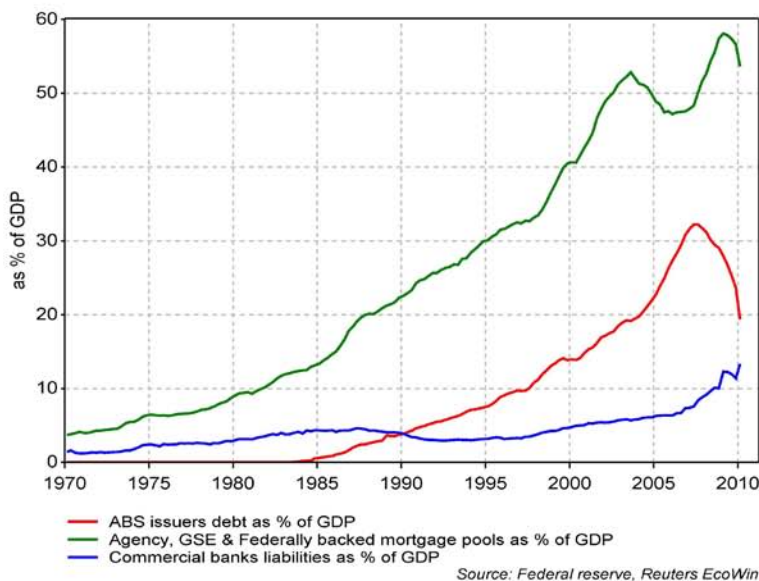


Debt backing asset backed securities has fallen sharply from its peak in q3 2007 from US\$4.5 trillion to US\$ 2.8 trillion (latest data).

Rather than back these vehicles which invest in a variety of instruments including credit card receivables, student loan receivables, auto loan rec'bles, small business loan receivables, investors are choosing to invest in either corporate debt or primarily US sovereign – i.e. confidence has not been restored to this market post the breakdown of trust

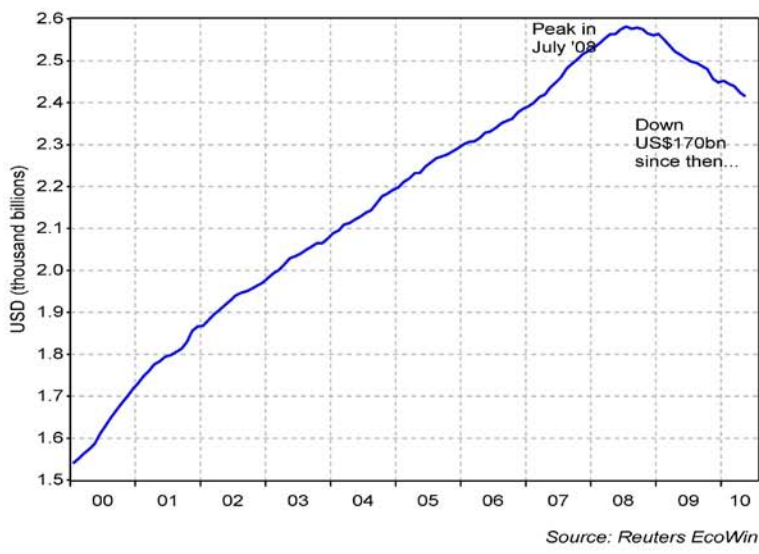


Fig 6: Total US financial sector debt – various sub sectors (as % of GDP)



As a % of US GDP, the collapse of ABS issuers outstanding debt has been dramatic. Similar, although, less dramatic deleveraging has occurred with agency, GSE & federally backed mortgage pools. Commercial banks have sought to counter some of that deleveraging but don't, especially given current uncertainty regarding future capital requirements, have the balance sheet capacity

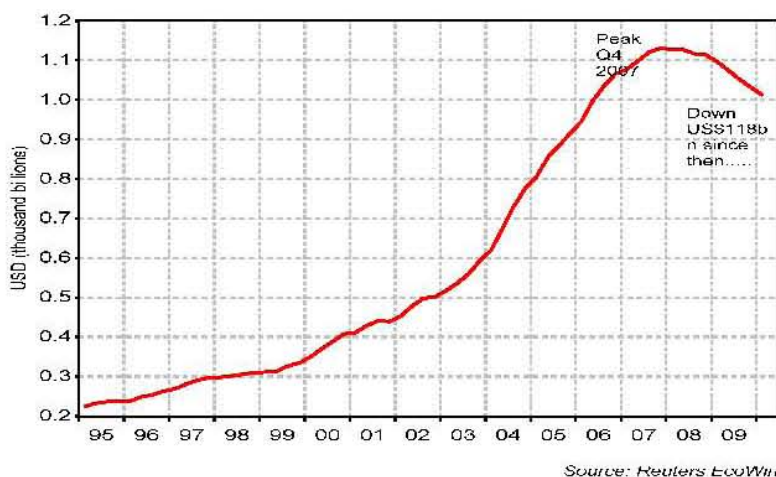
Fig 7: Total US Consumer credit outstanding (US\$tr)



Consumer credit deleveraging continues with the outstanding debt now US\$170bn lower than at its peak in 2008. As a share of GDP, while falling, the chart is less alarmist. Outstanding household consumer credit is 16.8% of GDP – down modestly from its 2002 peak of 18.5%, but not that meaningfully higher than the 1965 – 95 average levels of 12.5 – 13.5% of GDP



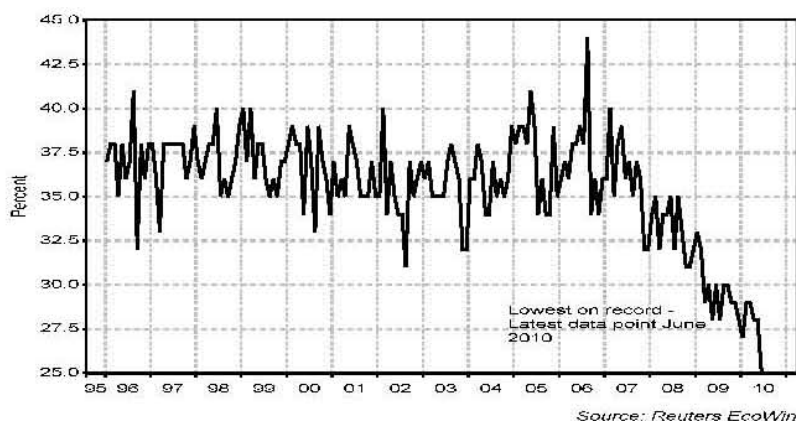
Fig 8: Total US Home equity loans outstanding (US\$tr)



Having peaked in Q4 2007, home equity loans outstanding have since shrunk by US\$118bn (in part due to write-offs; in part deleveraging)

Continued contraction would equate to reduced economic demand (i.e. higher economy wide savings)

Fig 9: US NFIB survey – small business borrowing needs satisfied (index)



While the availability of credit (question) for small business is off its lows, albeit still at low levels, small businesses report record low levels of 'borrowing needs being satisfied'

Other risks

On top of those risks highlighted above, other non-US specific global macro risks also exist which could contribute to the anticipated continuation of the crisis period that Howe & Strauss and others foresee. Of particular note are the risks of a break-up of the Euro as well as a collapse in Chinese economic growth – both of which have been discussed extensively in recent months.

Over and above those factors, there is also the risk of sharp and sustained inflationary pressures from a commodity price spike. China's appetite and dominance of most commodity markets is well known. A persistence of its rapid growth rate, in defiance of the China bears, could, if coupled with continued rapid Indian growth, lead to a major and generalised commodity price spike.

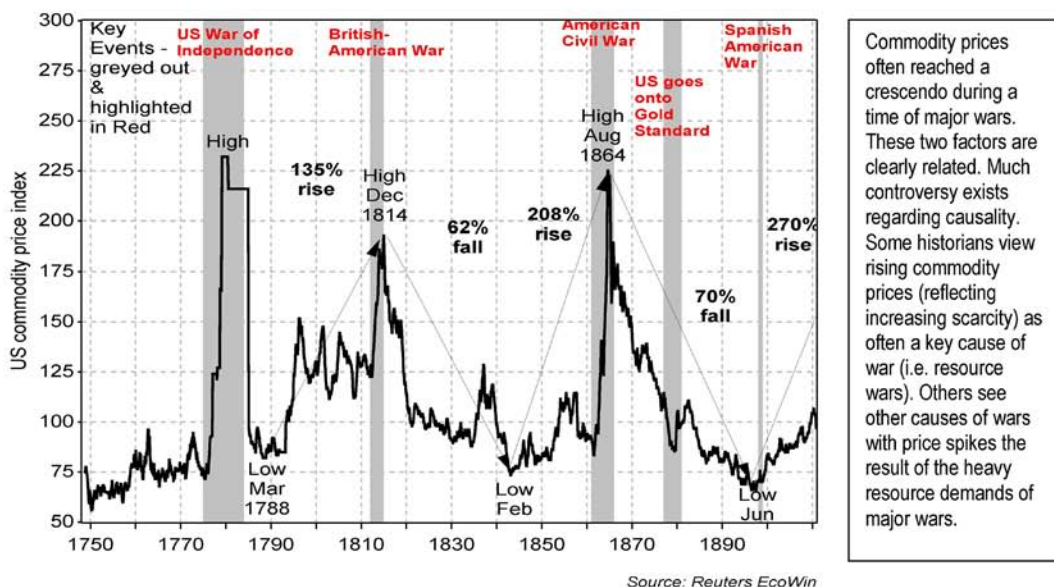


Section 2b: Geopolitical risks - Possible Resource Wars and Commodity price spikes

Commodity super cycles have historically often, although not always, peaked during a major global war. The peak in December 1814 was coincident (and probably driven by) the British-American war; the peak in 1864 occurred at the time of the American civil war (fig 10); during WWI prices more than doubled with that cycle peaking in 1920, shortly after WWI's end. Prices also doubled during WWII and eventually peaked in 1951, 6 years after the end of the war (see Longview Letter no 26, June 2008: "Commodity Super Cycle: Myth or Reality?").

Historians debate causality between the wars and the price spikes. A number claim that rising prices created the conditions for war (i.e. ever increasing cost of resources leading to 'resource wars'). Others suggest that other factors brought about war which then, in turn, due to the heavy resource demands of war as well as associated supply challenges, drove commodity price spikes.

Fig 10: Commodity super cycles (1750 – 1900)

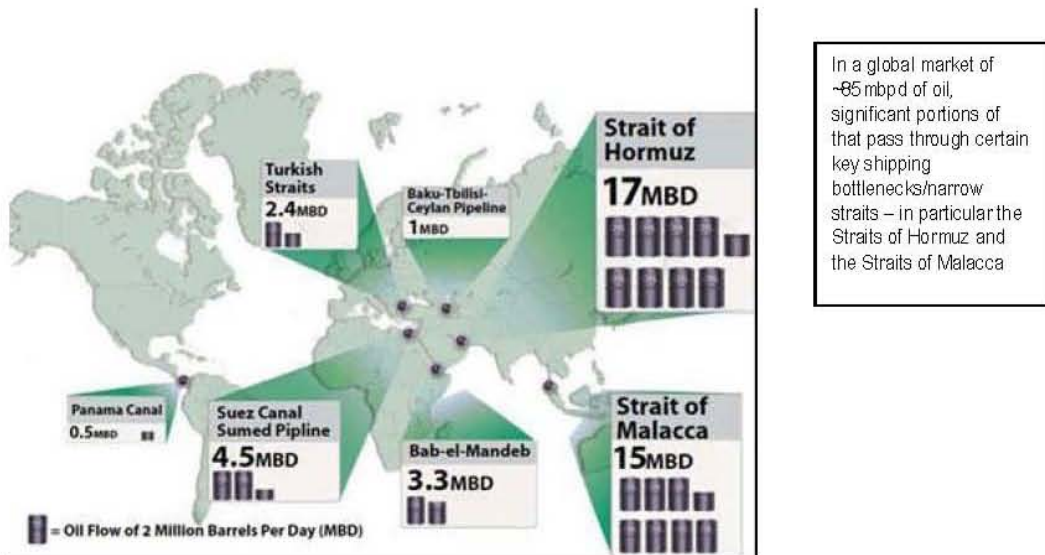


Either way it's clear that a number of emerging countries, most notably China and India, have rapidly increasing demand for commodities. Those countries also have limited domestic commodity reserves. China, for example, holds only 1.1% of the world's oil reserves, 1.3% of the world's gas reserves and 14% of the world's coal reserves. Already, though, China accounts for approx 10% of global oil consumption; approx 50% of world coal consumption and 3% of world gas production. By 2020 we estimate that China will consume over ½ the world's annual coal production; 20% of the world's oil production and 15% of global gas production (see Sep 09 Part 2 - Natural Gas - Long term for detail). India, whilst a smaller economy, is undergoing similar trends: i.e. growing rapidly with associated rapid growth in commodity consumption.



Given that lack of domestic supply and low level of reserves of key commodities both China & India have considerable reliance on overseas suppliers. As such China, in particular, is engaged in putting in place a number of measures to secure its long term future supply of key commodities. This is most obvious in its energy security policy. Both the Straits of Hormuz as well as the Straits of Malacca are major bottlenecks for the oil trade. According to the US Joint Forces Command (The Joint Operating Environment 2010 report), every day 17 million barrels of oil pass through the straits of Hormuz and 15mb through the straits of Malacca. Much of that is bound for China. Indeed China and India are the 1st and 3rd largest importers of oil (respectively). China imports approx 5mbpd; India approx 3.5mbpd.

Fig 11: Major global trade chokepoints/bottlenecks for oil

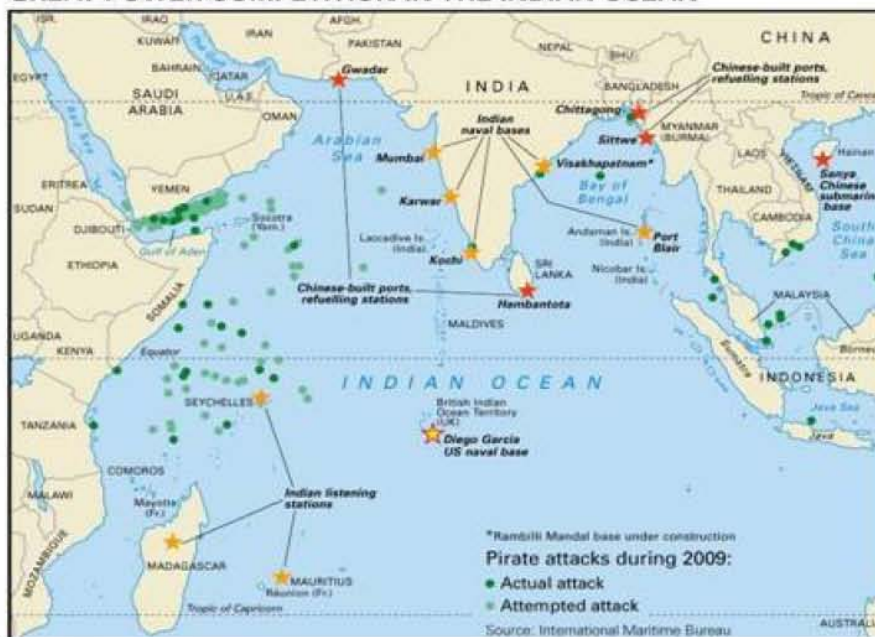


Source: US Joint Forces Command

In order to protect that energy supply, and in particular China's dependence on the Straits of Malacca as a shipping route, China has been building a major naval presence – both in the South China Sea but also in the Indian Ocean. As the map below shows China has built a "String of Pearls" – i.e. a string of deepwater ports & refuelling stations in Pakistan, Sri Lanka, Bangladesh & Burma which surround India and enable the PLA Navy (i.e. Chinese navy) to project and maintain force within the Indian Ocean. This is clearly one, of many, examples of an area of potential future conflict.



GREAT POWER COMPETITION IN THE INDIAN OCEAN



China has increasingly been projecting naval power in the Indian Ocean, in large part in order to protect its energy interests/imports in/from the region. China has built a 'string of Pearls' of naval bases around the Indian Ocean and surrounding India (with bases in Pakistan, Burma, Sri Lanka and Bangladesh)

Table 3: Chinese and Indian oil Imports by source (as % of total imports)

From	To	
	China %	India %
US	1%	1%
Canada	0%	0%
Mexico	0%	1%
S. & Cent. America	7%	6%
Europe	0%	0%
Former Soviet Union	11%	1%
Middle East	41%	70%
North Africa	4%	3%
West Africa	16%	11%
East & Southern Africa	5%	1%
Australasia	1%	0%
China	0%	0%
India	0%	0%
Japan	1%	0%
Singapore	3%	2%
Other Asia Pacific	11%	3%

Source: BP Statistical Review of World Energy 2010

China, in recent years, has successfully and aggressively diversified its oil sources in order to strengthen its energy security. While both China and India are major importers of oil from the Middle East, only 40% of China's imports come from that region (vs. 70% of India's imports). China also imports considerable amounts of oil from the former Soviet Union (incl. Russia, Kazakhstan, Azerbaijan). It also imports a lot of oil from East & Southern Africa as well as 'other Asia Pacific'.



Conclusion:

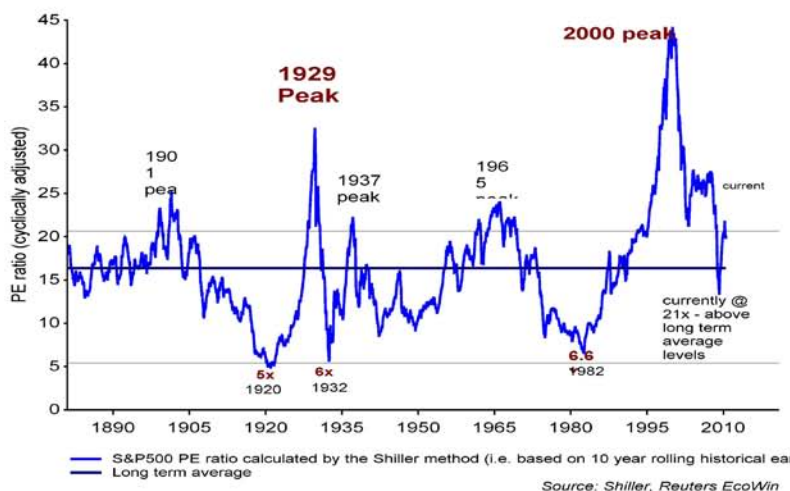
A number of global macro economic challenges exist which could contribute to ongoing macroeconomic turbulence and a fulfilment of the Long Cycle patterns outlined by a number of leading economists and historians.

Following on from 3 decades of rising total economy indebtedness (as a % of GDP) in the US (and west), a process of deleveraging is now underway. How long that deleveraging lasts is impossible to know, based as it is, in large part on confidence. Previous historical examples of deleveraging have persisted for a number of years/decades (e.g. see McKinsey Global Institute January 2010 report "Debt & Deleveraging"). If correct, that would likely act as a major headwind for western economic growth and create a Japanese style lost decade environment in the west and a Japanese style secular equity bear market.

A persistence of a commodity super cycle, as outlined by Kondratieff, would also likely result in a continuation of this current western secular bear market. Resource hungry emerging market economies growing rapidly coupled with ongoing money creation in the west are strong underpinnings for that cycle. Resource wars may also, plausibly at some stage, add to commodity price strength. Other possible macro economic challenges include sovereign debt crises in major western economies (with Italy, Japan, Spain, the UK & the US as key economies at risk).

While this list is by no means exhaustive it illustrates a backdrop of overstretched economies which have become increasingly vulnerable to shocks and as such unlikely to deliver sustained multi year robust economic expansions. That coupled with an equity market valuation (in the west – see fig 12 below) which is above average (when examined on a cyclical basis) creates an environment in which this current secular western equity bear market is likely to persist.

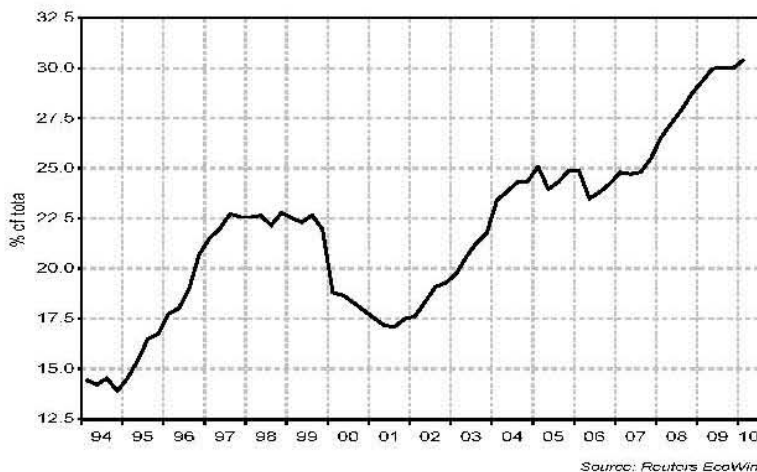
Fig 12: US Shiller cyclically adjusted PE ratio – Equities NOT cheap



Secular equity bull markets typically begin from structurally low cyclically adjusted PE ratios – the 1982 secular bull market began with a Shiller PER of 6.6x. The 1920 secular bull market began with a PE ratio of 5x. The 1951 to 1969 secular bull began with a PE ratio of 9x. The current high Shiller PE ratio of >20x does not support an expectation of a new secular bull market in western equities.



Fig 13: Foreign & International Ownership of US Treasuries (% of outstanding debt)



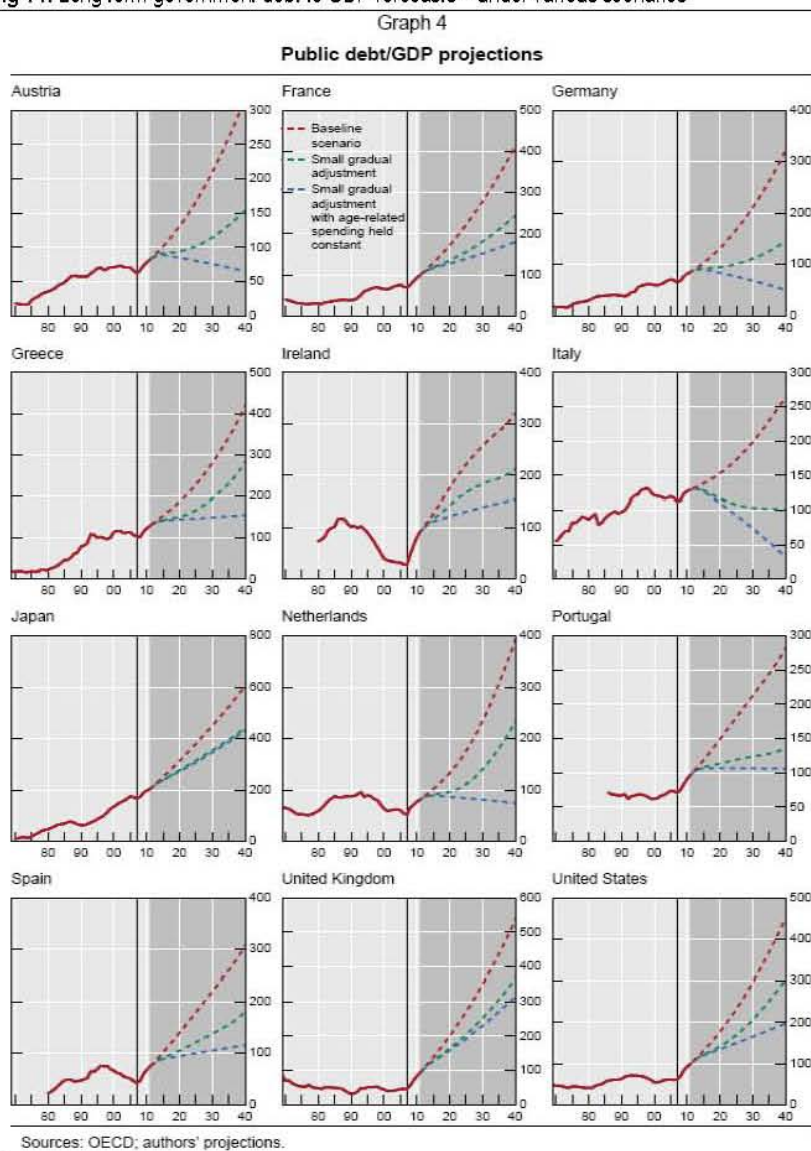
Almost 1/3rd of the US government's debt is owner by overseas holders. China & Japan are the two largest individual owners, holding between US\$800 – US\$900 billion each.



Appendix 1: Long term Government debt projections – under 3 separate scenarios

In March 2010, Cecchetti, Mohanty & Zampolli, under the auspices of the BIS, published working paper no 300. In it they examined the long term outlook for western (& Japanese) government indebtedness levels under 3 separate scenarios. i) A continuation of current government policies and the current structural deficit level (i.e. a continuation of how things currently are – this is the red broken line); ii) a small (1% per annum) gradual adjustment in the structural primary deficit for 5 years starting in 2012 (the broken green line); & iii) The gradual fiscal adjustment outlined in (2) plus holding government age-related spending flat as a % of GDP at 2011 levels throughout the projected period (the broken blue line).

Fig 14: Long term government debt to GDP forecasts – under various scenarios



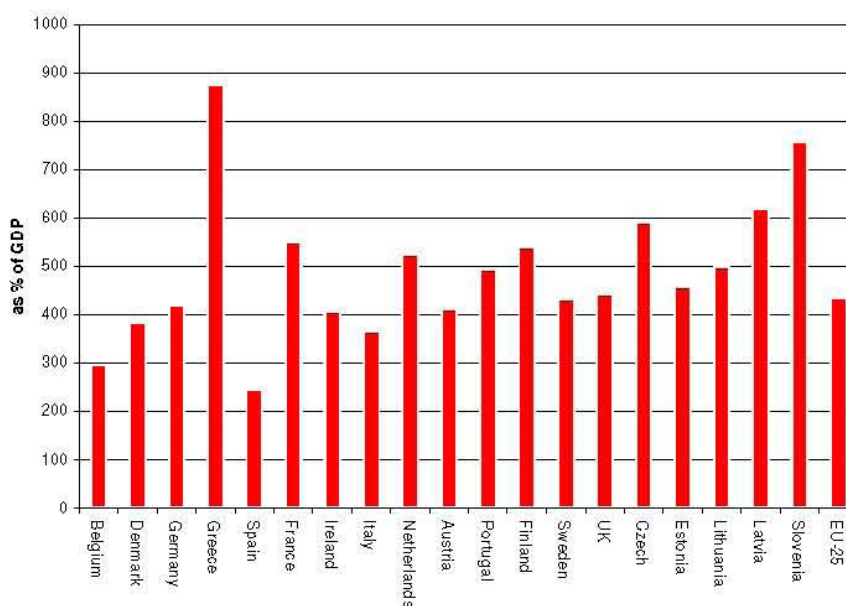
Source: BIS paper No. 300, March 2010, Cecchetti, Mohanty & Zampolli



As the charts show, even under the aggressive consolidation assumptions laid out in path (iii), government debt to GDP ratios continue to trend markedly higher for most of the countries shown in the analysis, most notably the UK (to 300% by 2040); Japan (to 400%+ by 2040); the US (200% by 2040) and France (close to 200% by 2040). Most of the other countries under such strong consolidation paths and under the Cecchetti et al assumptions for growth and inflation follow a more benign path, with government debt to GDP typically, although not always, falling over the forecast period.

These findings are further reinforced by a study by Gokhale (January 2009: "Measuring the Unfunded Obligations of European Countries" National Center for Policy Analysis, report no.319). In that paper Gokhale analyses the long term costs of current government spending plans. He utilises 2 key measures to demonstrate the size of the unfunded European obligations (generated in large part by ageing and, in places, shrinking populations); i) he discounts the future unfunded (i.e. unfunded by tax revenue) cost of all future obligations (stretching out 50 years) and shows them as a percentage of current GDP for each EU country (fig 15) – NB in this instance current GDP is 2004's GDP, and ii) he discounts future unfunded obligations and then shows them as a percentage of all future GDP, also discounted to present value. This measure represents the necessary fiscal adjustment which is needed to be enacted today (and remain in place each year over the forecast 50 year period) to ensure all future government obligations are funded. This measure is shown in fig 16 overleaf.

Fig 15: Fiscal Imbalance as a % of current (2004) GDP

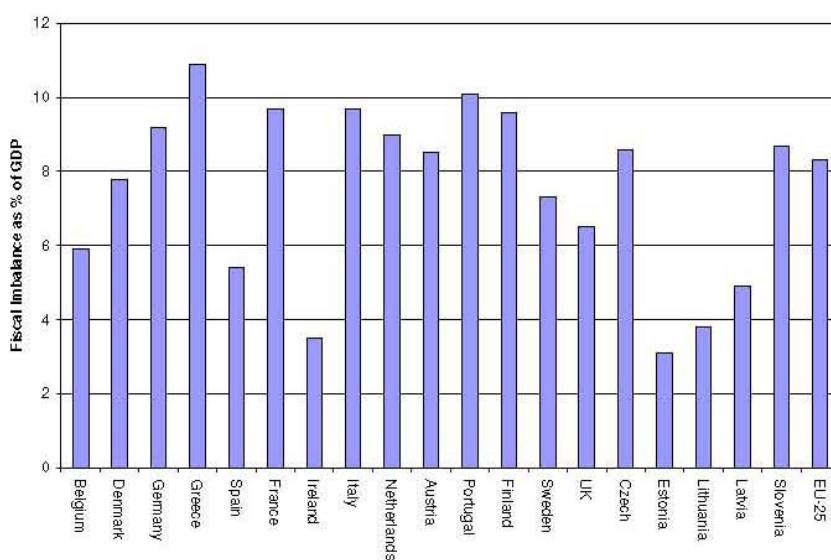


As can be seen from these charts, a similar message to that painted by the BIS paper clearly emerges. All of the EU countries have large fiscal imbalances, whether measured as a share of current GDP or of future GDP discounted to its net present value. Furthermore while the order of severity may differ from the BIS analysis, no doubt reflecting differences in calculations and assumptions, the message remains clear. All of the EU countries have significant fiscal challenges above and beyond the immediate challenge of consolidating the current fiscal deficit. Gokhale, in other work, also demonstrates that the US faces similar fiscal imbalances and challenges to the EU.



Importantly as well it should be noted that these challenges are not shared, on the whole, by the emerging countries. Better demographic profiles (i.e. typically growing and young populations) coupled with minimal entitlement programmes (i.e. health and pension), reflecting their lesser developed status, result in much healthier long term fiscal outlooks.

Fig 16: Fiscal Imbalance as a % of the present value of future GDP





Appendix 2: The Kindleberger Cycle

Approximately every 100 years since the C15th a new global economic power has emerged to take over the mantle of world economic primacy (table 4 - for full analysis see Longview Economics' Quarterly structural asset allocation No 1, November 2009: "Will the US\$'s Reserve Currency Status Persist?"). Kindleberger in his work on world economic primacy in the mid 1990s draws out 7 key conditions that have historically existed as leading world economic powers begin to decline and other countries emerge to take over that mantle.

Of those 7, Kindleberger noted that one of the key signs that a nation's world economic primacy is waning is when "finance...ultimately moves to trading assets and a preoccupation with wealth rather than output. Merchants and Industrialists graduate from risk taker to rentier status".

Alan Greenspan, former Federal Reserve Chairman, illustrates how this concept has emerged in the US in a 2009 article when he discusses the importance of asset price appreciation in not simply anticipating and reflecting but indeed **driving** an economic recovery:

"I recognise that I accord a much larger economic role to equity prices than is the conventional wisdom. From my perspective, they are not merely an important leading indicator of global business activity, **but a major contributor to that activity, operating primarily through balance sheets** (Ed. emphasis added)." Financial Times June 25 2009 **Inflation – the real threat to sustained recovery**, Alan Greenspan

The other 6 key preconditions for a decline in world economic primacy are listed below in table 4. There is a strong argument that the US fulfils 6 of these conditions. An argument can be made that they are increasingly close to fulfilling the 7th (i.e. condition 7 listed below).

Table 4: World Economic Primacy

Century	World Economic Primacy
C15th	Italian City States
C16th	Portugal & Spain/Hapsburgs
C17th	United Provinces of Netherlands
C18th	France (?) – France's world economic primacy is questioner by some scholars
C19th	Great Britain
C20th	United States
C21st	China-India – i.e. possible contenders for the C21 st.

Source: World Economic Primacy: 1500 – 1990, CP Kindleberger, Longview Economics

Table 5: Kindleberger's 7 preconditions for (relative) economic decline

1	Overindebtedness
2	Energy dependency
3	Foreign Policy overstretch – in particular military overextension
4	Financialisation of Economy – deterioration of manufacturing base
5	Political corruption – "consolidation of groups looking after narrow parochial interests" as described by Paul Kennedy
6	Currency debasement
7	Loss of technological leadership

Source: Longview Economics' interpretation of Kindleberger's World Economic Primacy 1500-1990



Appendix 3: The Howe & Strauss cycle - The Long waves

William Strauss & Neil Howe in 1997 wrote "The Fourth Turning: An American Prophecy". In it they lay out evidence for a long cycle in history (and within that, financial markets) that is driven by a generational memory with that cycle (and memory) running its full course over four whole generations – i.e. by the fourth generation the memories and lessons of the first generation have been essentially 'lost' – as such their mistakes are repeated. As table 6 shows the authors in 1997 were of the view that the US would enter its crisis phase in around 2005 (i.e. its fourth turning). The fourth turning is similar to Kondratieff's winter. The attached table below summarises the key historical points in those cycles.

Table 6: Howe & Strauss: The Anglo American Saeculum – an overview summary of the long cycle

Saeculum (i.e. 4 generations)	Time from Crisis to Awakening climax	(climax year) Awakening (full era)	Time from awakening to crisis climax	(climax year) Crisis (full era)	Full Cycle length (Crisis to Crisis)
Late Medieval				(1485) Wars of the Roses (1459 – 1487)	
Reformation	51 yrs	(1536) Protestant Reformation (1517 – 1542)	52 yrs	(1588) Armada Crisis (1569 – 1594)	103 yrs
New World	52 yrs	(1640) Puritan Awakening (1621 – 1649)	49 yrs	(1689) Glorious Revolution (1675 – 1704)	101 yrs
Revolutionary	52 yrs	(1741) Great Awakening (1727 – 1746)	40 yrs	(1781) American Revolution (1773 – 1794)	92 years
Civil War	50 yrs	(1831) Transcendental Awakening (1822 – 18??)	32 yrs	(1863) Civil War (1860 – 1865)	82 years
Great Power	33 yrs	(1896) 3 rd Great Awakening (1886 – 1908)	48 yrs	(1944) Grt Depression & WWII (1929 – 1944)	81 years
Millennial	30 yrs	(1974) Consciousness Revolution (1964 – 1984)	51 yrs?	(2025?) Millennial Crisis (2005? – 2026?)	81 years?

Source: The Fourth Turning, William Strauss & Neil Howe



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