

Capital Contradictions

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Diverse opinions about the coming year may shift into an “Inverse Goldilocks” outlook – some areas are too hot while others are too cold. Canadian housing turnover is at record levels and Chinese manufacturing and consumption are running hot, and both are prompting caution about sustainability. At the same time spending in the US and Japan remains weak despite massive government spending. Capital allocation underlies each.

The imbalances that created the Crunch were low borrowing rates *for* banks, and high capital leverage *by* banks. Central bank policy since the 1970s insists interest rates stay low to stimulate until inflation pushes them higher. A seeming lack of inflation came to be seen as a bonus for low wage economies supplying cheap goods and some services. However, inflation actually was rising, but focused on assets rather than consumables. Policy miscued by keeping bank rates low despite this.

The Tech bubble was overcapitalization that helped inflate valuation of many banks and near banks that feed off of the funding. As the banks’ share of public markets peaked after this hype, overbuilt sun-belts were generated by shoveling capital at potential house buyers in support of unsustainable bank bottom lines. This was initially blamed on too much capital. Capital excess perhaps, but in the end not excess capital.

The final excess was *overextension* of capital entrusted to the banks. Many banks, and their regulators, simply changed the rules and allowed more loans to be created than available capital should have. This was supported by sophisticated, computer driven economic modeling that had “fine tuned” the system. “Proof” this fine tuning worked was that the system hadn’t fallen apart when Long Term Capital Management miscued in the late ‘90s. Ahem.

The LTCM mess was covered by banks supporting its dismantling with rather large cheques. The system-wide repeat of the LTCM miscues had to rely on cheques from government, which is borrowing from everybody as a long term repayment plan. That is not true capital creation, but don’t take our word for it. Ask anyone in Japan.

Japan’s 1980s property bubble was fueled by banks overvaluing subsidiaries rather than reducing capital requirements, but it was still capital overextension that pumped up asset prices. Since then Japan has created by far the highest *government* debt load in the industrialized. At the same time it has continued to subsidize sacred cows like rice production. That sacred cow funding also helped maintain an aging post-samurai (sorta) system was presumably, um, a side benefit that has run its course.

Two decades of Japan sucking up domestic savings for recycling by its government has probably wrung the asset valuation risk out of that system. Deflation is still a systemic risk, though neither because bank capital is scarce (the original problem) nor because of over-capacity (the classic causation) per se. Japan has both a high savings rate and low unemployment, and yet there has been zero inflationary pressure on this economy.

Japan is the first functioning industrialized economy to suffer what we would call *demographic risk*.

Japan's population is declining, and growth stats rarely factor out population gains. Many rural and rust belt towns have shrunk due to ebbing populations, but that is because jobs have dried up and forced people elsewhere. Japan's problem is more psychological. Concern about export markets that has slowed recent capital spending has a real enough basis, but savings, the engine of true and sustainable growth, are still high.

Government debt is also high in Japan, but on this score the Yen sphere owes itself the debt rather than an outside lender. Perhaps it's time for the government to stop recycling funds, and allow the Yen to rise. The benefits of cheap imports might shift the mood enough to let an inventive culture to sort out how to spread wealth around fewer mouths. We imagine an Adam Smith or two will pop up to help the cause along, and inching interest rates up to move the process along isn't likely to do any harm. This would be throwing out existing economic models, but that's what should happen when they aren't working.

Unlike in Japan, the worst of the recent western bubble building had large dollops of foreign funds in the mix of capital that was overextended to replace low domestic savings. Other areas may have had a higher percentage of foreign savings in their mix, but the US had the largest amount. So far foreign capital has continued to flow in to deal with the crisis, but that flow may be cresting. Investing in America was meant to be low risk and with that parameter in doubt the high growth elsewhere offers better opportunity. At the same time Americans are paying down their debt rather than building or consuming beyond need. Low interest rates aid that cause, but capital could slow if it continues.

Canada's housing boom combines capital its banks maintained while others were overextending with current low interest rates. The Canadian savings rate hasn't been high by historic standards, but it never went negative as happened in the US. While the TSX is still well below its 2008 peak, Canadians sense commodities will sustain its gains. The test will be when interest rates turn up. The Bank of Canada has kept rates low in aid of non-commodity exports and is voicing discomfort about the boom mentality. Rising interest rates could hurt longer term; near term risks center on downturns elsewhere. Canada's capital hasn't been overextended, but too much of it may be getting stretched in one direction.

China's resurgent boom has been aided by government funds, but from an excess built over the past two decades. Bank lending has grown hugely this year, but as we've noted before misallocation is a bigger issue here than running out of capital. This isn't to say China's growth won't slacken and obviously it will at some point. But right now the push is to bring several hundred million more Chinese into the industrialized economy before demographic risk arrives in the middle of the next decade. Since this population decline was induced it may well spur growth rather than dampen the mood as it has in Japan. In the meantime there is greater risk of overheating followed by fatigue despite China's weakened export prospects. If and when the Yuan is allowed to appreciate is the most important capital question in China. That could create a very rapid wealth shift, at least as measured by changed currency valuations.

That possibility more than anything else is shaping hard asset markets right now. Copper and some others are being held against the potential that shift will be a smooth one, while gold is being treated as insurance against its being volatile. Being prepared for either is the best preparation for both. We continue to focus on gold till markets move off of their current watching brief, and hope early 2010 trends offer a better gauge of timing on how best to focus the balance of next year.

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