NEW MINERVA REPORT

All In The Mind

There is little doubt that as far as world markets are concerned, what happens to the US economy is paramount to future returns. So when Alan Greenspan sits before Congress, and reports what the Federal Reserve thinks, the rest of the world watches. On 15th and 16th July, this is what occurred: Alan Greenspan reported to the House of Representatives and then to the US Senate respectively.

There are two parts to these sessions. The first is when Greenspan reads his report, (which has two written reports already presented to the Houses, to which he refers). The second part is when the various politicians ask him questions. In the written report the Fed lays out its economic forecasts. They were surprisingly optimistic. They expect GDP growth of 2.5-2.75% for this year, and 3.75-4.75% for next year. Unemployment is expected to fall from 6-6.25% to 5.5-6% next year, and inflation is to fall to 1-1.5%, down from 1-1.75% this year.

This looks very upbeat for the US, and therefore for the world economy, the question is: will these forecasts prove to be the outcome? If they do, then the prospects for the world's stockmarkets are much better than previously supposed. But, could it be that the Federal Reserve is trying to talk up the economy? In Japan, the central bank has effectively always talked down the economy. It recently said that there was very little else they could do to get rid of deflation. Readers will know that we have said in the past that the economics is very much a psychological phenomenon. How people spend and save is very much a state of mind. If people are worried about the future, they will tend to save and spend less. We stand by this assertion, but have to add that there is also one added factor, capacity constraints! By that we mean that eventually, no matter how good people feel, they will no longer be able to spend, because they have borrowed too much, and will need to pull in the reins a bit, or as Greenspan puts it, 'restructure their balance sheets'.

Greenspan knows that the consumer could finally be coming up to that capacity constraint. What he needs is for companies to start spending. This will give the US economy another injection of growth. Unfortunately many companies feel that growth is going to be sluggish, and instead of gearing up for growth, they are cutting costs, as they see little in the way of increased sales. So it could well be that the Fed is trying to induce companies to gear up for the growth that it is projecting.

We think that initially the Fed will be successful. Growth will pick up. The preliminary GDP figures for the second quarter support this, with a provisional 2.4% annualised growth rate. This surprised most commentators, who were expecting 1.5%. If growth doesn't come through, we really are in trouble. The US economy has everything being thrown at it: lower interest rates, tax cuts and huge government spending. If we get no response from such a stimulus, what else can be done?

FIXED INTEREST

The latest US GDP figures got a significant boost from defence spending. This demonstrates how important government spending is becoming for the continuation of economic growth. But, at the same time that the US government is spending, it is giving back some of its income in the form of tax cuts. It is officially estimated that the US budget deficit is $455bn. The US Treasury has said that it will raise

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$60bn in the next quarter. Although this will be a record after last quarter's $58bn, ironically, treasury prices actually rose on the news. Some had feared that $70bn would need to be issued. And herein lies another conundrum for the US economy! You may recall that we said that the Fed was trying to bring down long yields, and had said that, if need be, it would consider buying Treasury bonds to make this happen. On the other hand, by trying to ensure that George Bush Jnr. doesn't fall the same way as his father from a weak economy, the government will have to issue more and more Treasuries to cover the increased spending and tax cuts. It is hard to believe that only two years ago the budget was in surplus, and the issue of 30-year bonds was suspended. In fact there was talk that, with budget surpluses foreseeable for the future, government debt could be eliminated altogether.

Last month we spoke about the irrationality of markets with fixed interest stocks and equities moving in tandem, but for different reasons. Since then a lot has happened. The US Treasury Bond 10 Year Benchmark has seen its yield rise from a low of 3.1 on 13th June, to 4.4 now. At first sight that looks as if markets are accepting the view that deflation is no longer a problem, and that economic growth will come through, just as Alan Greenspan is predicting. There is an interesting twist to this situation, and it is to do with mortgages. In answer to questions from Congress, Greenspan said, that it was unlikely that the unconventional measure he had previously alluded to, (the Fed buying Government bonds), was unlikely to be needed. He didn't rule it out, he said it probably wouldn't be needed. But a lot of consumer demand has been enabled by the re-mortgaging of properties at lower interest rates. These rates are the longer term rates, the very ones that have risen sharply in the past month. Ironically, as these rates rise, the mortgage corporations, who will anticipate lower mortgage demand, will sell US Treasuries, which forces yields upwards. Just to help things on their way, hedge funds knowing this, have been shorting US Treasuries, hoping to buy them back at a lower level. They know that they can exacerbate this vicious circle, and profit from it. But hedge funds will have to take a profit sometime, at which stage the tide will turn. If it doesn't, then Greenspan's bluff will be called, as he will have to buy those Treasuries to get yields down so that re-mortgaging doesn't come to a standstill. The other big holder of US Treasury bonds is of course 'the rest of the world'.

China's Currency

Listening to the questions being asked of Greenspan, you get an insight into the concerns of American politicians, and therefore the pressures that are being placed on the authorities. There were a number of questions he had to face about the deteriorating employment position in the US, and in particular how Chinese policies were making thinks worse. The contention is that the Chinese have pegged their currency at too low a level to the US dollar. This means that their goods are too cheap in the US. This in turn means that US manufacturers are being forced either to go bust, or to relocate their production to China. Greenspan said two things in reply. Firstly, that the movement of labour intensive production has been going on for years, and that this was a good thing. Secondly, in order to keep their currency pegged to the dollar, they have to buy dollars, which in turn means US Treasuries. He said they were 'heavy' purchases of US assets. He thought that holding this peg will create an inability for the economy to function well. It will become increasingly evident that existing pricing structures will not be able to hold. This is very interesting, because we believe that in the long term it is the Chinese that hold the key to world economic growth, not the US. But this is some years down the line. They can not float their currency at this time without endangering their economy. Too many 'bust' state companies could fail in that environment. They could re-peg the Yuan, and this may be an option they will consider in the next year or so. What is really needed is for the Chinese to open up their economy more, and this is what they are doing. They are addressing problems such as property rights. Empirical studies show that when GDP per person reaches $800-$1000, where China now is, economies go into a period of self-perpetuauting growth, as demand for high-end products takes off. Demand for capital machinery means that Japan actually has a trade surplus with China.