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Torrents of Liquidity – Building a Tsunami

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Ashok Dhillon has 40 years of front-line business experience in Canada and International markets. He incorporated his first construction company in 1974, and since then has founded and led companies in construction and international power development.

Over the last 20 years Mr. Dhillon, has led and worked with top Canadian talent in the legal, engineering and accounting firms, such as Fasken Martineau, Russell & DuMullen, Stikeman Elliott; Hatch, Moneco Agra, New Brunswick Power, SNC Lavalin; and Ernst & Young, Arthur Anderson, and Grant Thornton. And in London, worked with Perkins Couie and Morgan Grenfell. Mr. Dhillon's companies have partnered and worked with Pan Canadian Oil & Gas, WestCoast Energy, TransCanada Pipelines, and international companies such as AES, Enron Power, Hyundai Heavy Industries.

Mr. Dhillon has worked and negotiated with highest levels of Governments in Canada and India. He has pursued and won mandates to develop power plants in Canada, and foreign jurisdictions such as Hungary, Iran, Pakistan and India with uncompromising ethical standards. His extensive experience in securing and negotiating multi-hundred million and billion dollar mandates in power project development, gives him in-depth knowledge and intuitive insights into macro and micro, national and international, geo-political and economic realities and trends.

Mr. Dhillon has been invited to speak on international business at various forums, including as an expert witness for the Standing Senate Committee, Government of Canada, on "The Rise of Russia, China and India".

The global economies are slowly recovering, showing some weak positive numbers to encourage the optimistic, and giving support to the policy makers, even though these numbers are like mirages in the desert, showing up one month and reversing (*or disappearing*) the next. The numbers in almost all the major economies, be they GDP growth numbers, employment figures, manufacturing, import/export numbers, Purchasing Managers Index (PMI), or capital investment, are so transitory that they leave one rubbing ones' eyes and wondering if we had actually seen what we thought we saw.

So let us ignore the surface noise, and look deeper into the underlying realities of the major economies to discern the real trends, as that is our self imposed mandate.

To tackle the subject of the current macro-economic status first:

- *The total World Output is estimated at 3.1% for 2013, unchanged from 2012 but significantly down from 3.9% in 2011;*
- *Advanced economies are downgraded to 1.2% from earlier estimates of 1.3%;*
- *The Emerging Markets and Developing Economies GDP growth is downgraded to 5.0% from earlier estimates of 5.5% in April this year, (2013).*

The approximate breakup of those numbers is:

- *The developed economies range between negative lows of -1.80% (Italy), -1.6% (Spain), and to positive highs of 1.7% (United States), 2.0% (Japan);*
- *And the major developing economies posting estimated growth of 2.5% (Mexico) to 7.8% (China).* [Recently China downgraded their 2013 estimate to 7.5%.]

(All numbers are from IMF "World Economic Outlook Update, July 9, 2013")

We think these numbers are optimistic. Put yourself in the shoes of all the governments and central bankers who are desperately trying to show that their ongoing stimulus spending, bailouts and propping up of the global financial firmament - so that the sky does not fall - is working and justified. And, that the trillions of dollars already spent in the past 5 years have resulted in some positive impact on the economies. Being in that desperate position, to show that they are on the right path and justify staying on that path, they must show progress, regardless of how slight and ephemeral it may be.

One can readily imagine the legions of senior government bureaucrats and their agencies throughout the world, working day and night to massage the numbers to show the best possible results. We have a very difficult time imagining the opposite - governments and their agencies being absolutely upfront and reporting the real numbers, regardless of their weakness.

So we recommend that the numbers being trotted out, be taken with some skepticism. But even at face value, the numbers are not terribly encouraging.

Europe at its best is barely in positive territory with Germany at 0.3%, most other Euro

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economies are in the negative. Euro Area cumulatively is posted at -0.6%, and Canada and the United States (*North America*) are estimated to be at around 1.7%. The emerging economies of Asia and South America while showing good growth numbers at 2.0% to 7.5% are appreciably **slowing.** Brazil is being downgraded to 3.0%; India is heading towards 5.0% from 5.6%, and China possibly heading to 7.0% from its current estimate of 7.5% (*in spite of the Chinese Government vowing to defend its growth rate vigorously at 7.5%*).

The worrisome aspect of the above numbers is that they are the best result of the extraordinary monetary and fiscal effort of all governments and regions, working in tandem, to boost economic activity and thus hasten global recovery. If this is the best after five years of an all out effort, then we fear the worst is still to come. The developed governments are reaching their outer limits of stimulus spending and are being forced to start "tapering". They have been pushing and holding interest rates to their lowest levels, and are now being forced to raise them (*most of the developed economies are and have been at or near 0%*).

Of all the major economies of the world, the developed economies are the weakest. While the United States and Japan are showing the best GDP growth numbers, 1.7% and 2.0% respectively, they are also the ones that are getting deeper into debt the fastest, with the most aggressive stimulus programs that are creating new dangerous highs in the markets. Majority of the European economies are still posting negative growth rates this year and are heavily burdened with extremely high unemployment rates, especially amongst their youth. Except for their stock markets the developed economies are still deeply mired in the 'long recession'.

Meanwhile the emerging economies are caught in the conundrum of trying to boost growth rates through stimulus measures, because of falling exports and overall demand, while at the same time fighting internal inflationary pressures and inflating asset bubbles through high interest rates. The high interest rates put real downward pressure on economic growth, forcing these economies into a precarious high-wire balancing act that makes them very vulnerable to external and internal negative events.

In our estimation, and as we had anticipated since the beginning of Q3, the most expensive and much sought after economic recovery has been a ***mirage*** so far, fading in and out on a daily basis and leaving everyone guessing if it is really there.

So far the global economies have been inflated and held up by easy and cheap money. Obviously those two levers are coming to the end of their effectiveness. So what is going to keep it all going? We don't think anything can. There is too much debt being piled on with no real productivity to back it up, and the endless loose liquidity is goosing the global financial system to irrational levels, making it ever more vulnerable to too much speculation in the stock, bonds and real estate markets. So in our opinion, first must come another contraction, unfortunately with a lot more pain, which the governments have been desperately trying to avoid, which will sop up the excess liquidity and some of the debt (*which will have to be written off*) and then the economies will start the real recovery. Eventually the economies will recover but not yet.

As to the question why we anticipate another setback to the global economies - being handicappers our answer is 'past performance'. There are just too many structural imbalances in the global economies that were never corrected, and some that couldn't be corrected during this time. So looking at past events we see that the basic and fundamental problems at the advent of the last crash were, first and foremost, over

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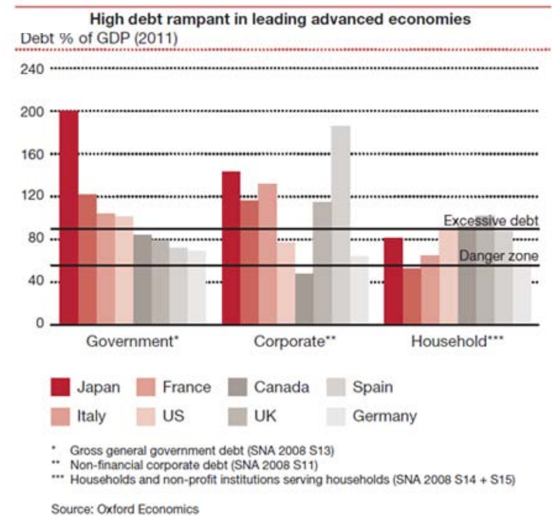
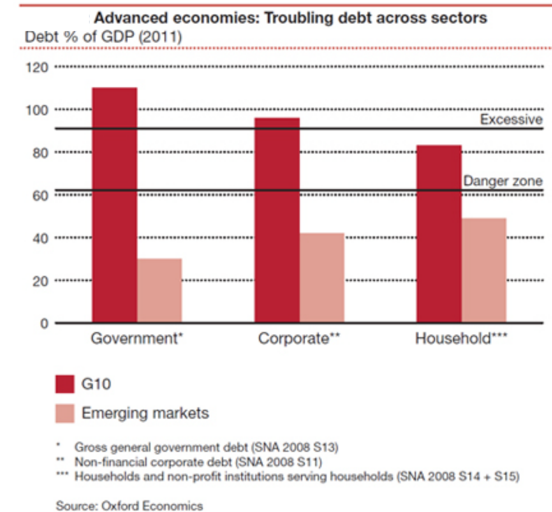
indebtedness of western governments and consumers. Secondly, unmitigated greed, downright fraudulent practices, and irrational exuberance in the financial and the real estate markets lead to a near total worldwide financial system collapse. Thirdly, there was the interconnectedness of global financial markets that allowed the corruption, contamination of bad investments, and overleveraging to spread to all parts of global banking. And finally, the interdependent nature of modern trade that brought major exporting countries down because the countries they were heavily reliant on, (*where the crash was triggered*) suddenly and dramatically reduced their demand. The net result of all of the above was the greatest financial crash of recent times, and a global recession that still persists, in spite of unprecedented stimulatory actions by governments worldwide for almost five years.

So is that where it is all heading? To answer that lets take an inventory of the above reasons and see if things are any different from the last time.

We have identified the facts that prior to the crash western governments, institutions and consumers were heavily indebted and overleveraged. If we are to look at the current indebtedness of western consumers and governments, we note that there has been some deleveraging on the consumer side, but most consumers in the West are still dangerously indebted, and western governments are much more so. In Europe some governments have **more than doubled** their debt burden since pre-2008, to a point that their debt is over 200% of their GDP. Almost all others, in the effort of the past five years to halt the freefall of their economies, have increased their debt levels dramatically as a percentage of their GDP. The United States has increased its debt to an estimated 113% of its GDP, and Japan to over 200% of its GDP. Both countries are continuing to pile on unprecedented amounts of debt, in the trillions per year, in their effort to revive their moribund economies. In effect the western economies and governments are significantly more indebted than prior to 2008, and while the consumers and the corporate sector on the whole is relatively leaner than before, they still carry dangerous levels of debt. The fact is the western economies are dramatically more indebted than in 2008 and dangerously so, as the following Oxford Economics charts from 2011 show. *Since then the debt levels are higher still.*





http://www.pwc.com/gx/en/governance-risk-compliance-consulting-services/resilience/publications/preparing-for-payback.jhtml

As can be seen from the above chart, the Emerging Markets are much less indebted across all categories compared to the western economies, and are growing at significantly higher rates of GDP, in the range of 4.0% to 7.5%. But, those growth rates, while seemingly robust, are far less than at their peaks pre-2008 of 9% to 12%, **and are continuing to decline** due to the serious drop in export demand from

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the West. Additionally, out flows of foreign direct investments and inflationary pressures from declining currency values, are resulting in governments pushing up interest rates to attract in - and slow down out-flows of foreign investment, and are slowing economic growth, particularly in the two largest economies, India and China, which are significantly off their peaks. The conundrum we mentioned above, of trying to boost growth while keeping interest rates high to contain inflation - attract investment inflow, and dampen speculation.

Fundamentally, the developed economies are barely growing and are ever more indebted, in fact dangerously so. And the emerging economies are significantly below their peaks and struggling to maintain their growth rates in the face of ongoing lack of demand from the West. Plus they have general overcapacity internally, relatively high interest rates and inflationary pressures from declining currencies. We feel that overall conditions have in fact **deteriorated** since 2008. On top of these very strong fundamental obstacles of significantly increased indebtedness of the West and slower growth of emerging markets, are the dangerous and systemic factors of corruption, unmitigated greed and rampant speculation in asset classes, both in the West and the East, adding considerable and growing risk to the global financial system.

In the West, particularly in the asset markets, many of the players are behaving exactly as they had prior to the 2008 crash. Stock, bond and real estate speculation is rampant, driving prices, valuations and indices to new record highs. In addition, we continue to get news of traders and bankers in the U.S. and the U.K., two of the most influential financial centers in the World, being involved in illegal practices such as insider-trading, manipulation of LIBOR - bank - and mortgage rates, metal and energy prices, and many other forms of financial skullduggery. The banks and individuals involved are not obscure lower-lings but iconic names and institutions in the international financial markets. The frequency and endemic nature of such malfeasance speaks to an entrenched culture of corruption that is unrestrained and unmitigated-greed driven, and due to the financial power of the players, is basically above the law in most countries. The fact that very few major players are ever successfully prosecuted and jailed, and that major banking and other financial services institutions can pay hundreds of millions of dollars, in penalties and fines, without admitting or denying any wrongdoing, and without ever being prosecuted, a legal precedent not available to regular people and businesses, insures that these practices will continue to proliferate, posing a growing and ever present danger to the financial system. It has gotten to the point where articles are being written in the popular media about bankers in the West going back to participating in all the practices that had brought on the previous crash.

In developing markets corruption is endemic to the system. In all major emerging economies, Brazil, Russia, India, China, and South Africa, political and financial practices are riddled with corruption, nepotism and nihilism. As these countries face the challenges of a significantly slower growth trajectory over the coming years, the corruption in politics and finance will take a heavier toll, have a greater impact and pose a major risk to economic growth and political stability. Currently, the corruption and possible political instability in India, Brazil, Russia and South Africa will not pose any particular great threat to the western economies except to put further drag on the global economy. But China is a whole different matter.

China's inner workings, be it political, industrial or financial, are inextricably intertwined and opaque to outside analysts. Yet enough details can be gleaned from independent sources and

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from officially released data that an educated guess can be made of the approximate state of China's internal affairs. Very serious levels of corruption saturate all levels of China's political governance. To make matters worse, all aspects of private and public sector economic activity is fully controlled by the one party political machinery. In other words, no part of China's economic activity is free of corruption. The past decades of breakneck economic growth, and the late Chairman Deng Xiaoping's exhortation to his Party members and the Country - "Poverty is not socialism - To be rich is glorious", has been taken to heart by the majority of the people, and particularly by China's governing individuals and agencies, of which there are many. Most everyone that can and is an advantageous position to do so, is hell bent on getting gloriously rich regardless of the means. When the global economies were roaring along pre-2008, and China's growth was above 10%, the country was making so much money that all sins were affordable, so to speak. In the current environment of declining growth and a seriously overstretched economy, the habitual behavior of self enrichment by the all-pervasive party members, bureaucrats and public sector workers, and private businessmen, by any means and at any cost, can inflict heavy damage to the Country's financial institutions. At this time the financial sector is flashing red.

China's banking and shadow banking industry, due to the exposure to the overextended real estate market, the overbuilding of infrastructure and the current overcapacity in industrial production, is the most prominent risk. These three areas of overbuilding - real estate, infrastructure and industrial production - are to a significant extent controlled by the provincial governments that have seriously overextended China's banking industry. And to the extent that the Central Leadership wants all activity scaled back, the provincial officials, now used to a certain standard of living, are simply unwilling. A sharp retraction in any of these activities could trigger a banking crisis in China that would have serious repercussions in the international financial system.

International analysts have analyzed this growing threat and have taken comfort in the fact that China's government has proven itself adept, time and again, at managing crisis and 'soft landing' the threat. Additionally everyone takes comfort in the fact that China holds over 3 trillion equivalent of U.S. dollars in foreign reserves. The reasoning being that with that kind of a war chest China can manage almost any financial risk. We feel that it is precisely when everyone is certain that an event cannot possibly take place that it needs the greatest watching, because almost anything is possible given enough instability, and at this time there is great instability in the economic system. The other reason that we are not quite reassured is that China is opaque, and no one knows for sure the true magnitude of the threat. At this time of tremendous global economic weakness, China's economic instability and rebalancing problems could be a serious threat to global financial markets and economies, due to the interconnectedness of them all.

The other weakness that is negatively impacting global economic recovery is the overall drop in demand in consumer consumption. In the West the consumers are still overleveraged and therefore have limited spending capacity, even if there are some signs of spending resurgence. One must remember that a lot of the seeming resurgence is from the deep bottom that all economic activity sunk to post the crash.

In the emerging economies, as we have seen from the above chart, the consumers are much less indebted, and their saving rates are generally much higher than the West. But, these consumers are nowhere as wealthy as in the West, and their spending power is a fraction of

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the consumers in the developed economies. In addition, the consumers of the emerging markets are now feeling the effects of the prolonged global recession and the loss of altitude of their formerly high flying economies. This declining economic trajectory points to the possibilities of layoffs and the retraction of recently acquired prosperity, which certainly is not conducive to fostering spending confidence in consumers. We have already seen this new reality manifest itself in the dropping sales figures of international corporations in automobiles and consumer durables. We see a continuing softening in consumption demand in emerging markets.

So to recap, let's examine the fundamental factors that we identified as key to the crash almost five years ago, and see what has changed, if anything:

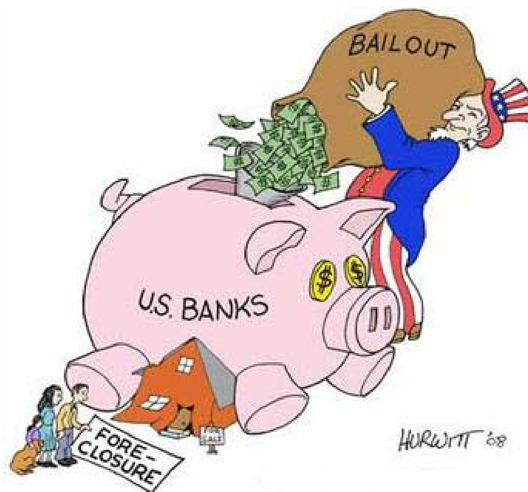
- Since 2008, the debt levels are significantly much higher in almost all developed economies, and in fact are climbing well past the danger zones in all categories.
- In Emerging Markets, though the debt levels are generally a lot lower, their economic growth was so dependent on the consumption of the West that in lieu of that demand their growth rates have significantly declined since 2008.
- The governments are running significantly higher deficits, printing a lot more of stimulative money, devaluing their currencies and fighting inflationary pressures particularly in food and fuel prices. In other words, for most, their economic circumstances are far more negative than in 2008.
- Corruption and fraudulent practices are rife in the financial industry from New York to London to Mumbai, Shanghai and the rest of the markets, creating false valuations, rampant speculation and ultimately undermining trust and stability in the system.

As no real price was paid for past sins, instead the major players were in effect rewarded though billions in bailouts and bonuses, no lessons were learned and no disincentives were put in place.

In fact one can argue that the billons handed out then, and the billions being poured out now, per month, provides incentive for imprudent greed driven financial industry practices to remain firmly entrenched throughout the World.

The extremely stimulative policies of western governments and their Central Banks, over the past five years, has created a massive money bubble globally, with little to no economic recovery. Instead the unprecedented excessive liquidity is sloshing around in the global financial markets, spawning a new round of even bigger and more dangerous asset bubbles, in stock, bonds, and real estate markets, that are all rapidly escalating prices and valuations with not enough gains in global productivity and efficiency to justify them.

In fact the definitive signs of a growing recovery being trotted out by the Federal Reserve, the high flying stock markets and the reviving real estate market, gives us no comfort. We know that the stock and bond markets are dominated and controlled by institutional players, and they are flush with easy and cheap money from the seemingly unending stimulus tap, be they in the United States, Europe and now Japan, and are driving the markets up in a frenzy of speculation. Additionally, in the United States the institutional investors such as Blackstone Private Equity, have moved into the real estate markets, buying up millions of residential



houses and rental apartments, purely as an 'investment' play, with an eye to re-selling the houses at higher prices when American Moms & Pops can afford to re-buy them, and if they can't, they will rent the apartments owned by the financial institution. Institutional investors are not confined to the U.S. markets alone but are purchasing real estate in all the depressed markets, such as Spain, Portugal and Greece. We see these types of transactions as proof that all is not well with the real estate markets, as young individuals, families and the locals cannot afford to buy, and cash rich institutions are stepping into their place, thus further distorting the markets, and in the larger context the economies.

International trade and consumption is nowhere near the pre-2008 levels, nor is it going to be anytime soon. That fact has collapsed growth rates in the largest emerging markets, putting a further drag on the global economy and leading to a contraction in commodities markets and resource based economies such as Canada, Australia, Brazil and Russia.

All asset markets may rise further, fueled by the current "irrational exuberance". The massive money bubble created by the policies of governments and their Central banks is in turn creating additional bubbles, and lately Japan has jumped into this game with both feet. But in spite of all assurances by the Fed, the ECB and the Bank of Japan, that they will keep stimulus going indefinitely no matter what, we feel the end of this run is coming soon. Simply put, the trillions being printed and pumped into the global financial system, by all governments, has no productivity gain and value creation to back it up. In fact, as we have pointed out the global output has instead been steadily falling. All the negative factors present prior to the 2008 crash are equal or greater in scope today. All positive economic numbers are few and too weak to withstand the impact of building financial tsunami. We recommend preparation and a strong defensive posture from here on. It certainly cannot hurt, but not being prepared can hurt!