Newsletter April 2011




Welcome

Within all the turmoil and natural disasters that surround us, I will keep my focus on economic and financial impacts which are bound to occur at the end of the second quarter.
My heart goes out to all in New Zealand and my dear friends in Japan as they struggle to survive through these hard and uncertain times.
I will address what I view as the economic impact of the latest natural disasters both from a US as well as an international perspective.

Happy reading,
Nick Doms

Content

The battle for food and its prices

As I have written many times last year and warned that the rapidly rising commodities prices would ultimately be showing up on all our street corners and our supermarkets, well I hate to admit but my prediction is now coming true.

The logic behind my analysis was that a prolonged period of zero percent interest rates always results in a new bubble somewhere that is just waiting to burst.
That bubble was visible in the commodities market and specifically in the agricultural commodities, which makes it even more dangerous for the average consumer.

As I have said many times, we can scale back on oil, gasoline and energy any time we want but we don't scale back on food.

This first quarter, consumers have noticed higher food prices in stores around the country and to give you the bad news first; it is just the beginning and will become a lot worse than what you see today.

For the first time we see food producers passing on the extra cost of raw ingredients to the consumer because the ever-smaller profit margins are no longer tenable.

Dairy, grain and meat prices are expected to rise by a whopping 25% to 30% this year alone and such calculation is based on the newly released CPI (Consumer Price Index) figures for the first two months of 2011.
The core CPI rose 1.2% in January and 1.6% in February but such excludes what is referred to as "volatile components" such as energy and food.
Factor back in both components and one can see why food prices alone rose by 3.6% in the month of February, the highest rise in one single month since mid 2009.

The American consumer has no defense or recourse against this continuing phenomenon no matter what the "Savvy Shopper" or the "Coupon Lady" says.
It is pure reality that is finally setting in and people take notice but there is a big difference between the rise in food prices and gasoline.

History tells us that once food prices go up that they stay at such level independent of whether the underlying commodities go down in price and back to "normal" levels which is in sharp contrast with gasoline prices that fluctuate on a daily basis and even intraday.

Have you ever seen a grocery store change the price of milk, cheese, meat or flour during the day as you drive by? No, of course not, not even the next day.
That's why the coupon ladies are so busy. Not to save you money, but to make you buy more and in bulk and preferably items you would normally not buy at all, but Hey! It's on sale.

The American consumer, already on a tight budget and with less spendable income, will have to adjust to this new reality and this will be a hard and bitter pill to swallow for all.
We will no longer worry about how much we pay for gasoline when we drive to the grocery store or the supermarket; we will faint when the cashier tells us how much we owe for the few bags we just purchased.

Just to give one example so we can put things into perspective.
Americans buy bottled water at $1.49 per 9 ounces, which amounts to about $120.00 per gallon. That makes gasoline at $3.59 look pretty cheap, does it not?

The trend of higher food prices will continue and will really find traction in early or mid summer as we get the first results of crop yields. If my prediction is right, i.e. that 2011 will see another reduction of American crop yields by 10% or more, then food prices will rise by more than 20% annualized.

Also watch our corn, wheat and soybean reserves as that will be another indicator of where food prices are ultimately headed.
This is important because of export demands around the globe that are based on their own local crop yields. China and Russia being the two most important ones but also keep an eye on India and Africa and whether the first three will again ration due to climate changes and the impact thereof.

I will end this article on a lighter note.

It is not really such a bad idea for Americans to go on a diet and eat less, after all we have the highest bio mass index in the world and I think most bodies have enough "energy" stored within that we should all use efficiently in time of crisis.

ND – 03/22/2011

The Housing market

We all know by now that the housing market is not on the road to recovery yet and we certainly know all the statistics of low prices, high inventory, high rates of foreclosures and a slump in new housing because of the current market conditions.

However, a new phenomenon that has crept up as a result of all these difficult circumstances in the real estate market is certainly worth mentioning, and that is the residential rental market.

We have seen a gradual influx or overflow from the real estate market into the rental market which has caused a higher then expected and normal vacancy rate. Such may be temporary as some will indicate but I believe it is a phenomenon that will change the rental market landscape due to several circumstances which I have described below.

1) Properties for sale when prices are depleted and buyers struggle to get a loan will certainly result in owners trying to keep their property by offering it to the rental market at a competitive price even when such may be temporary to cover the cost of the mortgage, taxes and insurance.
2) Said new rental properties which are now readily available are strong competitors with existing apartment complexes, hence the fact the latter struggle with high vacancy rates ranging from 15% to 25%.
3) There is a discrepancy between the increase in available rental housing and the demographic changes when one looks at the latest 2010 census, which obviously results in higher vacancy rates.
4) Residents who used to live in apartment complexes now have the ability to pick and choose a single-family home, a duplex or quad in a quiet neighborhood for about the same price, so a shift has occurred.

What does all this mean when we analyze and predict what the new landscape will look like?

For starters, I believe that the American Dream of owning a home is a thing of the past and one that will not come back because in my opinion it was just what it was: a dream.
There are several reasons to substantiate this drastic conclusion.
We need to realize that times have changed and so have family structures. During the post-war era, people married at a young age and bought a home with a 15-yr mortgage.

The home they purchased was free and clear by the time they were in their 40s but such is not the case anymore.

We now live in a time where people buy homes much later in life and with a 30-yr mortgage or even a 40-yr, hence the fact that retired people are still paying on their mortgage when they retire.

That has financial consequences given that spendable income from social security is far less and that has now given rise to the popular reverse mortgages for anyone over 62.

I will not go into details about what the repercussions will be 10 years from now from these new and creative instruments but suffice it say that even the housing market landscape will look dramatically different than what one might envision.

That brings us back to the popularity of the rental market versus the housing market. Just add in one more factor which is about to change if Congress gets its way: the elimination of mortgage interest deductions on tax filings.

So now ask yourself the question what incentive a 35 year old couple would have to buy a home with a 30 year mortgage without tax deductibles and full responsibility for taxes, insurance and maintenance versus renting without any of those responsibilities?

The rental market may see a high vacancy rate but such will only be temporary due to the sudden influx of available properties in a very short term and I do believe that the current imbalance will correct itself over time, meaning we should see a very active and healthy rental market going forward although the competition will be stiff for those that own property which is not up to par with others that are readily available.

The demands of current and future residents will only go up and landlords will have to keep pace with such in order to continue to be successful. Only a few years ago it was a "plus" if the apartment had a washer/dryer connection, today residents want the washer/dryer to be there in addition to a dishwasher in the kitchen and soon a microwave will become a kitchen staple instead of an extra.

ND – 03/26/2011

Japan, China and the US Economy

Japan is certainly struggling with one of the largest nuclear disasters in history and while the battle is far from over, we can already predict what the outcome will ultimately be.

My heart goes out to all my friends and their families in Japan but I will focus on what the economic impact will be instead of writing about potential radiation fallout and those dire consequences.

Whatever happens to the Fukushima-Daiichi plant, Japan's energy policy will take a 180-degree turn and away from nuclear energy, meaning that the current 30% energy supply will have to come from traditional fossil fuels or renewable energy.

This dramatic change in energy policy will put an extra burden on an already deflationary economy and will have far-reaching repercussions for the global economy and specifically the US and China.

As a result, Japan will experience not only a change in internal energy production but the fallout will also dramatically reduce their exports and put pressure on their currency, as we have witnessed in the last two weeks. That will change the landscape of the currency markets and therefore affect the US even though I believe that China may be affected negatively as well, in which case we should brace ourselves for a double impact.

Japan has no choice but to start massive quantitative easing by printing trillions of yen and pump them in the system to keep their currency from becoming unsustainably strong. We already see this happening with the yen reaching pre-war levels of 79 to the USD and now hovering around the 81-82 level, which is still too strong.

That direct monetary intervention is affecting the US in the sense that the Federal Reserve, who's intention was to implement their exit strategy in anticipation of an inflationary wave, will now have to postpone such and has no choice but to continue with QE in order to keep the dollar from rising too rapidly.
That in itself puts us in a bad spot given that our exit strategy and the planned interest rate rise during summer to keep inflation under tight control will now be postponed and replaced with a new wave of monetary easing.

Both contradict each other and one cannot battle high inflation with a forced upon monetary policy, so Bernanke is really in a pickle and has his work cut out for him to find a very narrow balance by trying to battle both at the same time.

The China syndrome or fallout will be different but will ultimately affect the US as well.

China will experience a much slower growth due to the Japan disaster and subsequent policy changes. While some, including Timothy Geithner, may view this as good news, I believe this to be a bad omen for the global economy.
When our global production engines slow down, then that is bad news for the largest consumer in the world, i.e. the US.

One solution could be when the US starts investing in manufacturing and production, but we are years away from this happening. Add to this the fact that the US remains indecisive in its fiscal policy with high budget deficits, high debt/GDP ratio and an ever increasing outstanding debt and one can easily see that these are not normal times.

The other impact for the US is how we will adjust our own energy policy after the Fukushima disaster and signs are already there that nuclear energy, dormant since the 1979 Three Mile Island disaster, will be heavily scrutinized and delayed.
Southern Company, through Georgia Power, who intends to get full permits to build two new nuclear plants, Plant Vogtle, at the Savannah River is already facing questions and delays because of safety issues.

The economic conundrum, which we thought would be resolved by now, is getting a long tail because of global circumstances that were unforeseen but nevertheless point out the fragility of our global economy. We can no longer think inside a closed circuit and we have to watch carefully what happens in the world before we implement a local monetary or fiscal policy if we wish to recover economically.

Today we wish to prepare and battle increasing inflationary pressures in the US and yet our hand is forced to do the exact opposite because of circumstances.
That is certainly not an ideal position to be in, to say the least, and one that can only be resolved by making a harsh decision.
Sitting on the fence at this point in time will not be an option and will prove to be very painful from a pure economic perspective.
ND – 04/02/2011

The new invention: Co-Co bonds

Within or after any financial crisis we see the birth of new financial instruments based on prevailing regulation or imposed restrictions and this time is no different from others.
While the world was anticipating the implementation of Basel III, the financial industry was already working hard on how to use the new guidelines in their favor, hence they invented Contingent Convertible bonds or Co-Co bonds.

Unlike the traditional convertible bonds, Co-Co bonds become convertible within a preset timeframe if and when the issuer's Tier 1 Capital Ratio falls below a specific percentage as set forth by Basel III. If such does not occur prior to the earliest date of conversion, then the bond rate will be reset at the prevailing 5-yr Treasury rate plus a predetermined premium.

Let's use the recent issuance of such by Rabobank who issued 2 billion USD of Co-Co bonds earlier in the year at 8.375% (2016-2049) with a coupon to be reset in 2016 at a 642Bp premium over the 5-yr Treasury yield. While the issuer is rated AAA, their Co-Co bonds are rated A, which did not stop institutional investors from oversubscribing the new issuance by 10:1 given that all are in search of a higher yield in a depleted interest rate market.

In the aftermath of the subprime and securitization disaster of 2007-2008, it would seem contradictory that yet again investors are willing to take a casino bet at the roulette table hoping that this time reward will offset the risk.
Yet at the same time we should remember that when central banks push interest rates to near zero that financial institutions, hedge funds and other large retail investors will seek a higher rate of return. After all, that is what central banks really want and indirectly encourage.

The question now is whether these synthetic bonds will become another cause of concern given that CDS contracts are already being issued against them. It will take little time before we see the repackaging of these Co-Co bonds into ABS, CDO or similar formats and one can guess what the consequences will be.

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