Macroeconomic Outlook | Notes Demonstrating Knowledge of Finance & Economics

Introduction

The following article comprises my general world economic outlook. It is necessary to clarify a few points for the reader. Firstly, the exercise is positive rather than normative. For example, any mention of oil should be read as an inchoate view of where world oil prices, or supply and demand, may go in future periods, rather than a statement that policies should pursue increased oil output, or that carbon fuel consumption is net surplus enhancing. The same reading can be applied to everything written here. My role as a researcher so far is to forecast macroeconomic events. Though it is constrained by data analysis and well established economic theory, it very much suits my tendency to examine how things work and apply that understanding forward. Normative notions of what should and shouldn't be are political by nature, and though, like all individuals, I have political viewpoints, my role as an economist is primarily positive. Because what follows is outside the constraints of data analysis and flows largely from predictive social organizational philosophies, rather than the conventional economic theories I am obligated to abide by when commissioned, it is to me a highly entertaining and creative process. I hope that any readers with a similar inclinations also enjoy it. In addition to a creative exercise, these views form my own personal experimental foundation on which new global economic theories can be constructed, as I progress in my new role.

That said, the discussion alludes to a general economic forward consensus. It is in fact based on forecasts constructed by the most proficient forecasting teams, with the broadest and most accurate data sources and most advanced economic models in the world, like the IMF's world economic outlook. It also incorporates general information reported from multiples of news sources, including the Wall Street Journal and The Financial Times. Finally, it is given that the likelihood of economic outcomes is stochastic, in that reflexive processes and actions between participants change probabilities dynamically. Therefore, as with fund management, real-world forecasting is a seemingly endless process of theorizing, positioning, re-theorizing and repositioning. These views should therefore be interpreted as a snapshot, and in any case used more to stimulate ideas rather than suggest positions. Readers interested in the philosophical aspects of financial theory may find it more interesting to skip to the end of the article. Those making investment decisions are advised to seek further investment council.

Japan

In general economists are bullish on Japan. As inflation edges toward positive numbers, the long period of deflation and stagnate growth nears its end. This is triggered by recent easing of the money supply that has seen the yen fall off relative other major currencies. Japan's major challenge has been recognizably growing; debt per GDP is approaching 250%, the largest of any country in the world. Though current deficits remain near 3% of GDP, questions remain if it will be feasible to maintain any kind of fiscal health with a skyrocketing share of budget expenditures going to debt service. The caveat is that the ratio of debt that is internally held is high relative other major nations. This prolongs the extent to which Japan can carry its debt load without serious problems; because, in theory, authorities can negotiate with debt holders, or in any case simple print and pay. Recent debates over the advantages of consumption tax increases in Japan are signs that authorities recognize that failure to reduce the debt is as risky as raising taxes. The former could contribute to a very real risk of rapid explosion in government bond yields, high interest rates and ultimately enhanced capital outflows, while the latter invites deflationary forces to an already historically deflated environment. The resulting tension demands that Japanese authorities carefully package policies aimed at increasing investment and limiting government expenditure so as not to create the appearance of debt monetization.

There is an old lesson that lends itself well to the Japanese position. The crash of 87 supplied ample evidence that Japanese markets do not operate under western principles. Though the nation is widely considered more open now than it was in 87, the willingness for internal market participants to hunker down under personally unfavorable policy moves, for the greater good of the nation, remains greater than in western nations. The intuition is that bond markets in Japan could likely stay healthy without an immediate tax increase or even a further broadening of the corporate tax base. Thus the more pertinent question is, to what extent will a tax hike negatively affect the GDP deflator? One view is that the answer depends largely on credit flows inspired by Abenomics; where will the enhanced monetary base go? If, for example, easing only increases foreign borrowing along with externally held debt, more likely if an interest rate differential between the US and Japan is expanded, the problem is only magnified. On the other hand, if the money supply was increased homogenously across the nations consumers, and those consumers were then taxed on consumption, the portion of new money allotted to each consumer that was spent (on domestic goods and services) would incur taxation that would then go to reduce accumulated deficits. Not only would process be GDP enhancing, it would also influence spenders to not only save, but to invest abroad. Increased savings would increase domestic investment, while investment abroad would contribute to downward pressure on the yen offsetting any upward pressure that resulted from the expectation of lower debt.

From this angle it is the impact of Abenomics on the domestic velocity of transactions that is most important in determining the outcome of taxation on growth. Currently what we see is that Abenomics has inflated stock markets and increased domestic consumption, while the lower yen has also contributed to domestic consumption (by increasing the costs of imports) while offsetting waning export demand from emerging markets. This is so far evidence that the policy has been successful; however, the extended period of economic malaise in Japan, along with the easing, creates ideal conditions for the formation of a boom bust cycle, though these days such formations are frequently neutralized by the collective knowledge that they exist. The tax policy then speaks to any tendencies the Japanese authorities have toward conservative market management. This analysis, albeit brief and exploratory, suggests it is in the interest of authorities in Japan to raise taxes. Outcomes will be contingent on not only other world developments but also the occasional fly in the ointment, but in general, signs of continued growth should see the yen etch out a price floor versus the US dollar, while an increase in consumption taxes should be overall favourable for Japans economy. Equity markets in Japan should fall on news of the tax increase, while bond markets should rise. Movements in the yen are of course subject to economic forces in the other majors, but in general further easing should apply downward pressure on the yen, while taxation should result in upward pressure.

US

The current consensual forecast from the economic community is a slight return to US health with a rise from 1.9% GDP growth in 2013 to 3% GDP growth in 2014. Recent housing start indicators, motor vehicle sales and fed commitments have supported these forecasts and, in general, commodity driven currencies and developing economy currencies have fallen off sharply vis-a-vis the US dollar.

There is a substantial indication from the investment community (Bridgewater, Fisher Investments and more) that the turn-around will be substantive. Fisher Investments has pointed out that GDP growth indicators are not ideal measures of economic activity because they incorporate only net trade, while improvements to imports are also signs of increases in consumption. They punctuate this with data showing exports grew in the 2nd quarter; net trade dragged on GDP only because imports grew more quickly. The indication is that, despite emerging market slow-downs, US trade activity has not fallen off. The contrarian view–and it is always easy to take the contrarian view–is that US bound capital flows have increased prematurely. Contrarians would point to a FED commitment that is contingent on a reduction in US unemployment to 6.5%, while growth forecasts are unlikely to bring employment down that far. Further, the US debt problem remains as intact as it has been, and it is a very significant externally held debt. The stabilizer process (in this case driven by a higher dollar) has the propensity to reinforce the debt problem while working against growth by dragging on exports. Though these outcomes would not occur quickly, expectations of them could. Combining these with the anticipation that the flight from emerging market currencies will overshoot any real valuations on the downside and capital is likely to bounce back and forth into the US dollar. Thus operational forecasts, at least at this moment, remain choppy.

A non-operational forecast for US growth, however, would need to be based on those factors that have made the US economy the largest in the world; primarily, innovation, entrepreneurship and a sound administrative and structural infrastructure (rather than external demand). These factors in my view are not only highly significant but have the potential to be understated. The general consensus is that developments in fracking technology have spurred rapid increases in US oil output that will drive the economy out of the rut. This would be combined with pent up demand for housing and motor vehicle consumption, which are already improving. Though this may be to some degree the case, there is ambiguity concerning the sufficiency with which these influences can foster a sustained medium-term turn around. One view is that these numbers can easily be adjusted downward on the grounds that there is an autonomous component to both housing and vehicle consumption. That is to say, lower interest rates may be enabling previously restricted autonomous spending rather than pushing consumption upward (consider the depreciation of motor vehicle stock that periodically requires replacement as a component of private autonomous expenditure). My view is that any real turn-around–one that can sustain a bull market in a timid and still deleveraging global economy–would need to be driven by something more substantial than slightly higher consumption, less volatile energy prices, and higher oil output. This is because changing US demographics, despite the probable reductions in cost attributed with Obama Care, combined with US debt, itself all the more likely to be problematic given rises in the US dollar, are going to weigh on increased oil output driven growth. For my commentary I want to look only at the rather obvious variables that can be expected to influence the changing speed and direction of US growth. These variables are innovation and US dollar demand.

With respect to innovation, my very strong view is that historically speaking the picture is monolithic. The extent to which the communications revolution is rapidly changing our world is underestimated. Not only has the revolution changed the global consciousness, in terms of human rights, the public's acceptance of autocratic authority and its stomach for conflict, it has also created conditions for innovation and invention that are unbounded. Further, these innovations are far more likely to spill-over multilaterally; more cause for them to settle and incubate in the most fertile grounds, currently in the US, for various reasons. With the latter in mind there is a very significant probability that unexpected innovations will support the US economic turn-around in the second stage (after the initial oil tech driven boom faces anticipated price reductions). This would reduce the time-frame necessary for a stagnate deleveraging (though it could easily lead to higher leverage).

The most visible manifestation of this likelihood is in the lower marginal cost energy revolution (LMCE). The revolution is forecast to have only a slight impact on oil consumption, an expectation based on slow market share growth, not only in industrial energy sources, but also in consumer uses, like vehicles and home energy. More likely is that consumers in high private debt environments will take so keenly to whatever products offer costs savings that growth in the vehicle and home energy lower marginal costs energy markets will explode. The additional surplus could be applied either to private debt reduction or to consumption. A higher savings rate in the US and an associated higher US investment rate would extend any longevity in the bull, but these are unlikely. What is more likely is a continued contraction of credit, sufficient only enough to stave off the deleveraging woes, followed by higher consumption and even further credit expansion.

On the bear side, which would see a slower growth trend, marked potentially by periodic lapses, not quite recessionary, but nevertheless detrimental, money demand and protectionism have the potential to be influential. Stimulus, not only driven by bail-out packages, but also deficit spending and lower interest rates has not resulted in measured inflation. In fact, the opposite has occurred, slightly. This is due to the liquidity trap, capital that has found its way into foreign markets, and to a misunderstood external money demand function. It is the money demand function that to me is the most nebulous. The best estimate I have come across for external US money demand is roughly 25%. This is not the highest in the world, which, by the same estimate is in Switzerland (50%). But by magnitude it is by far larger than anywhere else in the world. This is what makes the US dollar the global hegemon currency by default. Moreover, the official opposition, formerly required to achieve between 500 billion and 1 trillion in private and official holdings even to compete, has been dismounted by the ongoing Euro crisis and currently, at least in terms of holdings, is nowhere near viable. The external demand for the US dollar has allowed the FED to unabashedly monetize debt without triggering inflation or a sustained crash in the US dollar. But estimates of external money demand, at least in terms of the velocity of transactions (as opposed to holdings), are spurious to say the least. Unanticipated negative changes in US dollar demand, the result of store of value substitution or the long anticipated but never arriving release of the liquidity trap could result in rapid inflation, both in equity markets and prices of goods and services. Thus the rate of growth is sorely dependent on the consistency of the money demand function. Finally, the bear case is also sensitive to further external demand shocks, driven either by protectionism or serious slow-downs in emerging and commodity markets.

The protectionism case can be examined in other articles, but suffice it to say that the world economic slow-down did result in more protectionism, as was predicted by probably the vast majority of international relations professors. Recent solar product price floors in the EU, agreed to by Chinese exporters are evidence, as is the chicken and tire tariff exchange between China and the US, Australian barriers to auto imports and the (opportunity cost) of protectionism that has stalled various trade agreements, like the comprehensive economic trade agreement between Canada and the EU. Though there are strong views that protectionism encourages default in heavily indebted countries and eliminates comparative advantages that lower standards of living world-wide, as can be seen from recent protectionist trends, clearly not everybody agrees. National mercantilist tendencies surface in tentative global conditions because the benefits of protectionism are tangible while the costs less so. In any case, further protectionists sentiments have the potential to slow US growth.

My current hypothesis, subject to change, is that real-world US growth will hobble forward, beating 2013 expectations, wobble backward, as reflexive processes flag (potentially a pull-back in investment) then lurch forward again, ahead of expectations in the 4th quarter of 2014. Late 2015 would see the materialization of an innovation driven boom. Again, I emphasize the value of constructive prognostication is repeatedly subject to changing global circumstance and any operational strategies based on these views would be subject to repeated re-theorizing, repositioning and re-theorizing again–operational success is understood to be largely a function of process and positioning rather than proficient omniscience.

EU

Slightly negative 2013 growth followed by anticipated 1.1% 2014 EU growth has not been the main EU story. The survival of the Eurozone, followed by any legislative evolution, and any resulting affiliated hegemonic status, has been the primary market moving force in the EU. That is to say, bond spreads on the periphery, and recent higher than expected improvements in the euro versus the dollar can be interpreted as a function of expectations that commitments to maintain the Eurozone will remain stronger than incentives to let it collapse. The lower risk improves the function of the euro as a store of value. This in turn increases external euro demand which improves the euro's position as the official opposition to the US dollar in its role as the default global hegemonic currency. To be clear, improvements in the status of the euro as a store of value are not a statement suggesting the ECB will monetize debt, but rather that high liquidity and strong administrative support are no longer threatened by fears of collapse. Thus any closure reassuring the world that the euro has resolved its sustainability challenges will result in significant rises in the euro, renewed capital inflows and an associated real-world turn around. This outcome has already contributed to an over-valued euro relative the fundamentals and even as I write this article is taken up by the media which now cries that Eurozone growth has been underestimated and turns around.

My most recent view is that the ongoing vehicle for this change in EU perspective will be evolutionary. Probability outcomes in the Eurozone have been drifting between two extremes, namely Eurozone breakup and mandatory enhanced fiscal transfer. My view throughout this time-frame (though I was indirectly inspired to that view by a former professor) was that collapse was unlikely precisely because the creation of the Eurozone, and in fact, most of the moves toward a single market that have led up to it, have resulted in new power structures along with new institutionally self-preserving forces. The social mechanism at work here is entirely political. Politicians, by necessity are proficient in securing power. The same skills are then firstly applied to maintaining power–history has proven this reality repeatedly. Thus the Eurozone itself is its own most powerful advocate. This social force, combined with the anticipation of high Eurozone exit costs, greatly diminishes the probability of a Eurozone collapse, which now is supported by both policy initiatives and convention.

On the other extreme, the move toward a supranational fiscal transfer system is incompatible with the national interests of the mosaic of nations that comprise the zone itself. The subjugation of authority to transnational regime, even one that is collectively governed, goes against national interests deeply and is in this regard infeasible. The most viable solution, that splits the difference between these extremes, is one form or another of the various proposed risk sharing schemes. The most tangible to me, and I am certainly not alone, is the Eurobond. The introduction of a Eurobond, that would average risk levels in Eurozone sovereign debt markets, would instantaneously turn the euro into a viable alternative to the dollar, not yet in terms of external demand, but as a store of value–the former would follow the latter. However, without an extraordinary bull market to obscure the political risk to Eurozone sovereigns, it seems there is little chance for a Eurobond.

Here I insert my view on the likelihood of evolution by convention in Eurozone member-state co-operation, and the resulting debt market implications. As outlandish as it sounds, the view is inspired by studies on dictyostelium, the amoebae that cooperate under adverse conditions even though only a select few will reap the rewards of cooperation. Simplistically speaking, the model is one where nations avoid a Nash equilibrium by grouping together voluntarily in crisis situations because the costs of failing to do so outweigh the advantages of pursuing more mercantilist policy stances. It does not sit opposite the (brink) model discussed by Soros in 1986, which can be successfully applied to remarkable number of historical crisis–for example, the south Asian currency crisis, the Russian ruble crisis, and the Eurozone crisis–but rather sets a floor, by convention, restricting the extent to which cooperation in the Eurozone can deteriorate. The legislative manifestation of the policy model will see an evolution in credit markets instruments, intermediary systems, administrative institutions and conventions that will ensure collective reactions in a crisis without a break-up, a Eurobond or a more formative federal transfer system. My contention is that market participants are recognizing this eventuality, which is leading to narrow bond spreads, a sustained upward pressure on the euro, a decrease in bank's default buffers (lifting profits) and over-all confidence in the Eurozone. Looking forward, even slight moves at the policy level that promise to institutionalize crisis supporting market mechanisms will lift the euro, improve investment and lift internal demand.

Moreover, there is the already mentioned likelihood that the LMCE revolution will advance faster than anticipated. This is already forcing movements along the production possibilities frontier, while pushing it outward at a pace subject only to the time it takes to aptly reallocate resource. As mentioned, though the potential for innovation incubation may be higher in the US, due to external economies of scale and a more favourable entrepreneurial environment, that innovation can be more readily applied in the EU, because of a higher dependence on energy imports. Thus the LMCE revolution will likely remain at the forefront in the EU. Also, the benefits of that revolution, enhanced surplus, are far more likely to be applied to private debt than consumption in the EU as opposed to in America. This is a very strong case for a sustained turn-around in the EU and an early exit from the deleveraging cycle in the medium term, though it is contingent on further EU credit market reforms (or the expectations of them) and a more rapid realization of the marginal cost energy boom.

Sluggish EU growth forecasts, however, are based on more systemic issues, particularly at the periphery. These include, high unemployment (which can change the ratio of structural unemployment going forward), the inability of banks to supply credit to small businesses and start-ups, high private debt levels and a resulting low investment rate. On top of this, growth in the core has also slowed, though as I have pointed out credit market supply curves are more likely to remain flatter. At the root of this is a slow internal devaluation that has been drawn out even further by austerity demands imposed by the inflation wary core. The argument that weak growth in the core will constrain movements of capital from the core to the periphery is not supported by history. The countercyclical relationship between the core and the periphery was just as strong during the collapse of the European Monetary system (EMS). The analogy of tightening in the core externalizing disequilibrium on EMS, is not an exact fit for this circumstance, but the countercyclical nature of the two economic regions can easily be used to argue a slow-down in productivity differential growth rate can only result in relatively more competitiveness in the periphery, which is healthy for Eurozone stability. Still, a strong return to domestic demand in the Eurozone is likely to trail the same in other majors, and of course the developing economies, which have recently tapered off. With this in mind, though my view is long the euro fundamentally, this is primarily in the medium to long term. In the short-term, I look for speculative forces to keep the euro over-valued relative the fundamentals, for the aforementioned reasons.

China

My theorizing on china truly is formative. It is said that even specialist on China have little to go on that has predictive value, because economic information is subject to such high error. Further, it can be argued that the existing Chinese political equilibrium could only exist in such a place, and is therefore particularly difficult to predict. Where else do the vast majority of people support a corrupt, unfairly distributed and income diverging system, in a closed society, on little more than a kin-like national premise? Still, I am certain that more informed readers will scoff at anything I write here, and I only continue because the Chinese economic mystery is so great that even were I informed, informed readers would scoff anyway. My contention is that the Chinese economy, as it is believed to be by much of the economic community, is at an inflection point. However, I am as of yet undecided as to the more medium term direction of the change in acceleration. Clearly the model of a low renminbi and export oriented growth has reached its maturity. Recent credit restrictions from the Peoples Bank of China can be interpreted as a constraint on resources; not to say that the resources are not there, but more to say Chinese authorities consider it prudent not to extend those resources further. Regional banks and states have been warned that support for financial excesses is no longer guaranteed. This can be interpreted as a sign that a catch up process is necessary. The nation has refit its shoes and must now grow into them. The rapidly expanding middle class is attracting more and more attention from the lower income bracket. Long sustained growth has driven velocity of transactions, capital inflows have contributed to an expanding money supply that has resulted in higher prices. Explosive growth has expanded a structural infrastructure that now needs to be filled with world class legal, financial and political infrastructure. This would increase demand for higher paying jobs, allow further improvements to standards of living and move the Chinese economy into the next stage of growth. But will Chinese authorities pursue this initiative, and if so how?

These questions feed into the root of my misunderstanding of China. Intuitively, I have been in the camp that has looked at the dogmatic nature of social organization in China as unsustainable. I have been unable to reconcile the sentiments that led to the Tiananmen Square massacre in 1989, with the slow progress toward an open society. Instinctually, I anticipate a sudden breakout of public dissent that can only result in political upheaval and obviously, a rapid fall-off in growth. I have been reminded, however, that the parallel between the social demands in a western society and social demands in the orient is incongruent, such that my concern that all is not as it appears in the world's fastest growing economy are superfluous.

If I am correct, and the traditional Chinese forms of organization are unsustainable, the question evolves to examine the scenarios of either a controlled liberalization or an uncontrolled one. Either case is extremely bearish. A controlled liberalization, which would presumably come about through an acceptance of authorities that the only way to remain in authority is to liberalize further by spearheading the long-discussed move to privatization, would result in a significant period of confusion followed by a slow process of re-orientation. Growth under this scenario would slow tremendously, and then rapidly increase. It would be anticipated that what control remains in the economy would be used to influence the allocation of resources to avoid the kinds of problems that occurred in the Russian transition, but slower growth would result nonetheless.

A rapid collapse, on the other hand, is the nightmare revolutionary scenario, which would be associated with even higher levels of corruption and catastrophic power struggles. There would be initial rapid capital outflows, followed by an almost complete drop-off as private capital was deployed domestically in response to changing political power structures. If I am incorrect and the communist regime is sustainable, the question of regional debt-levels, higher prices, volatile capital flows come to the forefront. The demands for a more mature social contract remain, but would be less precipitous. Without further insights into the cultural mysteries of the Chinese social system, and a more detailed examination of what data is available, it is futile for me to try and measure the risk of political instability. All I can do is recognize that some kind of contraction in money supply is continuing to push on the renminbi in a way that cannot be contained by authorities. Though China remains a mystery, which weighs on its financial market, there are indications that the renminbi will continue to rise, especially against currencies under downward pressure.

Russia

The world outlook on Russia is that it has been at full capacity for some time and is now due to slow down. This was the case across 2011 and 2012 when GDP growth fell from 4.3% to 3.4%. The IMF GDP forecast for 2013 is 3.4%, leading to 3.8% in 2014. It appears markets are adjusting the more immediate forecast downward on falling demand for commodity exports and anticipated lower oil prices. Moreover, the logic goes, inflation rates, which have declined on average from a 2008 high of near 15% to closer to 3% in January of 2012, are now falling only slightly from 7% in January 2013. Not only is inflation volatile in Russia, it is also high enough that easing via lowering interest rates is no longer expected to curb recessionary pressures. The slow-down in emerging market commodities demand, and in forecasted oil prices, due to increased output in the US and Saudia Arabia, and despite lower output in Libya, Iran and Venezuela, has weighed in on the ruble with downward pressure. This has been largely mitigated by Russian Central Bank open market operations that target a more stable ruble/dollar exchange rate. Though in the short-run the ruble could fall off against the dollar rapidly (despite Russian central bank efforts) in the medium-term and long-term my hypothesis is, all else remaining equal, Russia can return to more substantial growth and a sustained rise in the ruble could ensue. This is for two reasons. Firstly, there are few countries with Russia's output that have so little debt. Though easing may not slow recession there is every indication that spending, especially on infrastructure, would. The second reason is that the release of Alexei Navalny can be interpreted as a sign that authorities want to pursue a controlled transition to a more transparent democracy, potentially under the expectation that such a transition has to be made to maintain power. Meanwhile, Putin has reminded the Russian people, by going against the US on the Edward Snowden affair, that he stands at the head of the only Russian regime that can to stand up for Russia on the world stage in the historical way. The offshoot is that Putin is very likely to prolong his reign, and there is every expectation that this will result in further infrastructure developments. These can include high speed trains and public transit infrastructures, rental housing to allow more labour mobility and various forms of gross fixed capital formation. Further, should demand rekindle in Europe and continue in China, Russia will see a re-emergence in exports. The opposite result, further downward pressure on the ruble versus the dollar, could come if there are uncontrolled moves toward greater political legitimacy and higher inflation. Currently however, I am in the short-term slightly bullish on the ruble, all else remaining equal, and in the long-term anticipating improvement, based on low debt, but subject to inflation conditions and external demand.

India

India is the under-performing emerging market. In decades prior the excuse was a poor transition from the Raj administration to a democracy. As in Brazil protectionism after the transition did not produce results similar to those achieved through trade liberalization in the South Asian miracles. The capacity for growth has remained, but an inability to optimally attract foreign direct investment, and to encourage the formation of successful multinationals, has led to sensitive export markets and a current account deficit that is 4.8% of GDP. Moreover, the former Reserve Bank of

India governor pursued contraction policies that have contributed to a fall-off in growth from 10.5% GDP in 2010 to 3.2% in 2012. During the recent emerging market sell-off, the rupee fell 12% to 61.8 per US dollar.

The newly appointed RBI governor, Raghuram Rajan, is not only regaled in economic policy circles but also considered a growth oriented Keynesian. The expectation is that he will seek to spur growth, potentially by risking lower interest rates, in spite of heavy inflationary pressures. In light of the India's current account deficit it is anticipated he will support protectionist policies, aimed at lowering imports and increasing exports. Finally, because India's slowdown is structurally driven, with industry heavily hampered by less than smooth transitions to privatization, it is anticipated that fixes will also be structurally focused. These would emphasize long-run growth while incurring short-run costs.

There are other developments in India that are noteworthy. Specifically there is the upcoming election that pits two economic oriented leaders with opposing view policy platforms against one another. The incumbent, Manmohan Singh, is known to favor more socially responsible policies; the opposition, farther to the right, is considered more business oriented. The outcome of the election could shift sentiments in domestic equity markets and foreign direct investment flows, though the impact of those sentiments would again be felt in the longer-term. Additionally, India is adding a 26 province, Telangana, which may have implications for one of its major business centers, Cyberabad.

My general theory, which I have tried to punctuate as still subject to testing and re-theorizing, is that downward pressure on emerging market currencies is likely to overshoot and that hot money is going to bounce between them and the US dollar (and now also the Euro). In the case of India, I am not convinced that this will be the case. Core inflation in India is already high, and promises to go higher, while successful policy fixes are not clear. Any sustained downward pressure on the rupee, that further raises import prices, could trigger an inflation depreciation spiral. The IMF projections for 2013 and 2014 GDP growth are 5.7% and 6.2%, respectively. In light of deeper structural issues and reflexive forces that may weigh on investment, despite structurally focused policies, these forecasts can probably be adjusted downward. In terms of the long-run outlook, slower growth would actually be a healthy sign, if it came as a result of structural improvements.

Austrailia

My view on Australia is limited, therefore here I will be brief. Declining demand for commodities in China is weighing heavily on the Australian dollar…it has crashed so far relative the US that it remains in question if it can go farther. Unfortunately for Australia, I don't see how it can. Though the decline in exports has left Australia open perhaps for the first time to recessionary pressures the rest of the world has been facing since the great recession, debt to GDP is terrifically low in Australia. While unemployment increases and tax revenue slows, the government lowers interest rates. Protectionism in the auto sector serves as an example of domestic consumption improving policies; more of these can be anticipated. The likelihood of infrastructure spending seems highly probable. Corporate tax cuts that are quickly setting the bar for upcoming elections would be more stimulating for the economy because the current debt levels are low enough not to drag excessively on spending multipliers. Lower energy prices and fiscal driven relief on downward wage pressures could keep consumption near current levels until exports pick back up again. This view is congruent with consensus forecasts that predict 2013 growth of 2.5% (recently revised in light of flagging commodity prices), a drop off from that growth rate in 2014, with a pick-up to new highs in 2015. Forecasts for 2014 growth rates could easily be adjusted on the upside, especially if global conditions improve. The recent fall-off in the currency market will likely overshoot on the downside, the first wave of this has already largely occurred. The logic is that speculative capital expects no new highs in the Australian dollar and has fled to the US on hopes of higher returns (and the locking in of prior gains). This will leave the Australian dollar undervalued, and some capital will find its way back. The Australian dollar (and the Brazilian real) are the primary examples of choppy currencies I am anticipating (while the rupee and the ruble can be expected to be less so).

Canada

The Canadian dollar, which has weathered the decline in commodity demand rather well, is now depreciating against the US dollar. The end of the global commodities boom did not hit Canada as heavily as it did Australia, because Canada sits next to the world's largest economy and is one of the world's largest oil producers. But even now the negative commodities demand shock is changing the outlook for Canadian growth. This is punctuated by receding potash demand and margins in Canadian mining plays that are so tight any potential further fall off in commodities demand could be matched with a run of shut-downs. This would drag on the TSX, though it hasn't done so yet.

Much of Canada's story will unfold as the global turn-around takes hold (either now or farther along in the deleveraging cycle, probably the latter). Recall my theory is that the lower marginal cost energy revolution will be rapidly unleashed and Canada has so far failed even to attempt to stay with the pack in renewable energy policies (like heavy solar subsidies). The dogmatic ideology that is driving the interaction between policy and energy is building up a very real cost that will be felt when outward movements of foreign production possibility frontiers force a productivity differential, leading to higher production costs in Canada relative nations more advanced in the LMCE revolution. Though, as I have stressed, outcome probabilities change rapidly in economic forecasting, such a productivity differential would lower exports, raise unemployment, push on tax revenues and potentially burst the real-estate bubbles, if they were not already burst at that point. Though it sounds very serious, there are only certain conditions that would make it so. More than likely such a force would simply drag on growth rather than pushing a recession–the real cost would be opportunity.

It is widely acknowledged that demand for housing in overheated markets like Toronto and Vancouver has been largely fed by immigration dollars. The notion that there is little in the way of real economic activity that can support housing valuations that are near to a dozen times average income per capita is not exactly true. Vancouver has a very strong port, significant investment and a very significant global mining sector. Toronto has manufacturing, finance and tech? Still, the housing boom has such immense property values that only immigration money can keep it going. Further, there is every indication that supply will continue to increase; developers have been profiting largely and condos continue to sell. It is not in the nature of these sorts of markets to cool on the supply side. The main question is if all the elements of a boom-bust cycle are really present–just how far from equilibrium are these markets? Boom-bust cycles are almost always credit driven. At the end of the day it is net worth of home owners and the propensity for that net worth to shrink with financial asset valuations that can force a sell-off. Any real understanding of the distance between market and equilibrium is dependant then on the role of credit in the housing markets, whether that credit is domestic or foreign. I will leave off that line of thinking there…

In the Vancouver case there are some interesting aspects of the market that are visible when one looks at the growth stage of the city, and at other cities that are older and have higher populations. In the case where high net worth home owners flood a market, the divergence between the incomes of renters and the prices demanded by landlords is a big issue. Highly priced neighborhoods demand an influx of renters that can pay. Thus immigration money has to be allocated to both sides of the market, which can be the case. Thus the boom can remain sticky in some neighborhoods and decline much more rapidly in others, especially as lower income demographics are pushed out of high priced regions. From an investment perspective, the model results in two sides to the market, those regions that will continue to rise, stay flat or only gradually flatten and those regions that will show a rapid fall of in prices–properties at the margin. This is my expectation for Vancouver, given the scenario where average million dollar property owners are high-net worth and not overly leveraged.

The flip-side of the scenario would be heavily triggered by political instability in Asia, which would profoundly influence real-estate in Vancouver (I have already discussed the potential for that instability). Should China show social stress that results in a decline of the communist regime, or should the long discussed transition to a privatized economy come about by more natural forces, a quick wave of capital could rush into Canada's real-estate markets followed by a closed spigot. In a scenario where real-estate markets are credit driven and Canada feels the weight of drying up demand for commodities, mining company shut-down rates increase and increases in US oil supply drop demand for Canadian oil, stagnating incomes and high debt would result in a wave of refinancing. Here the theory that Canadian banks navigated the recession because of some kind of national foresight, rather than the good fortune of having a common-wealth like view of the relationship between property owners and status, would be tested. A failure to systematically relieve debt-loads would see Vancouver real-estate falling off more quickly.

The current forecasts for 2013, 2014 Canadian GDP growth are 1.5% and 2.4%, respectively. I have no inclination to adjust the numbers until there are signs of more sustained growth in the US, and the rapid pick up of lower marginal costs energy use globally. If US oil exports decline, and emerging market demand continues to taper, look for the CDN dollar to continue periodically falling off relative the US, until it reaches maybe 80 cents on the dollar and then returning toward parity, as exports pick back up. Healthy export markets would reduce that depreciation perhaps only to 88 or 90 cents on the dollar.

Investment

In general my view is that markets are the ideal testing ground for predictive theories, because the results are so quantifiable. This is not to say that speculative investments are either the most profitable form of investment or first-best form of investment, in terms of total surplus including social health. The relationship between angel investors and entrepreneurs is probably among the healthier forms of investment because it stimulates real social activity and development. Cultures that focus on closer relationships between angel investors and entrepreneurs, as marked by initiatives that bring the two together, are more likely to see favorable growth in not only numbers living above the poverty line, but also education rates, and drop-offs in suicides (in Canada the Dragon's Den is a prime example, though in general one would expect public initiatives). Thus angel investing is a more socially profitable engagement than market speculation. Moreover, the slope of the yield curve is on average the steepest across the seeding stages and so primary market profits can be greater than those in the secondary and tertiary markets. In developing economies and third world economies, where social infrastructure can be fractured and even exploitive, rather than nurturing, positive externalities from primary investment would be even greater.

Ultimately even entrepreneurial endeavors are driven, or at least subject to, the profit motive. Without profit start-ups are unsustainable, which translates into extreme discomfort for the average founder. With this in mind, though the income gap in America is tragic and severely detrimental, there is no question that the philanthropic efforts of the worlds wealthiest are unparalleled in terms of…let us say…social gain per dollar spent. The moment the profit motive is removed from the equation (or even subject to a longer time line) blind spots that impede the development of a more prosperous and utility yielding social fabric can be addressed. Micro-lending facilities are truly a powerful way of achieving this directive. Finally, government investment, sometimes directed at optimizing the social welfare function, actually can have an extremely positive effect on social health. This despite the very valid arguments that it is inefficient, easily exploited and in many cases outright corrupt.

Now that I have relegated financial markets to the bottom rung, I can proceed with a brief explanation of my market philosophy. As I have already mentioned, my bent in life is toward forecasting and financial markets are the grading mechanism for predictive macroeconomic practices.

In any phase of the cycle it should be understood that value investing, over the long term, is preferred to swing trading, hedge fund management or any practice aimed at capturing short-term profits. This conclusion was reached by Keynes, in the latter stages of his investment career, passed on to Benjamin Graham, in some respects, and has manifested itself in as near to the platonic form as one can hope from a human being in Warren Buffets professional life. The value investment theory is well laid out in the Kenneth Fisher book, (Super Stocks.) The aim is to pick stocks of companies that will outperform the market by gargantuan spreads over time by identifying them in a crisis stage (when they go through growing pains and respond). This would be the case for a stock like Tesla, if it were to run into some serious problems and crash again (though miraculously it is probably not even a bad buy at the current price of $140 US). The other examples are countless and I will not bother to go into the details. The point is that value investing remains number one, if you can do it.

This leads to the obvious conclusion that picking individually outstanding equities was even more advantageous throughout the downturn, and even more so in emerging markets where corporate market shares can be expected to be more volatile (more cases where low market share companies will transition in to large market share companies). My focus has been primarily on macroeconomic movements, because my studies and work have been in these areas. Thus I am more attracted to looking at national market index futures, currencies and bond spreads and to seek out cross-hedges, than to focus on the hunt for super stocks. Were I employed in financial operations rather than applied economic research however, I would most certainly change this practice to include a microeconomic focus on individual equity fundamentals.

Financial Philosophy

The above views on the world economic outlook are formative hypothesis. The exercise is little more than a commentary on contemporary views on the world economic outlook. The reader will notice forecasting is rather haphazardly applied to both financial markets and real-world outcomes. I have at least tried to make the distinction clear between the two. To do this I used the terms operational success and real-world success (objective success), which are references to the Soros publication (Financial Alchemy.) The former applies to financial market place success (profit), while the latter applies to successfully predicting real-world outcomes (like GDP). It is understood that there is a reflexive relationship between market participants and market outcomes, and that this relationship can be extended to include real-world outcomes. While market information can never be perfect (because of reflexivity), it is typical of forecasters predicting both operational outcomes and real-world outcomes to seek perfect information (for example the magnitude of forward prices).

Alternative methods aim to identify not only the magnitude of imperfect information, but also the force and direction of reflexive forces in action. This is best described as a focus on fallibility, though I have only begun to describe it that way during the last 5 years, having only then discovered Soros. The process I have naturally pursued throughout the last few decades of personal development has been based on the investigation of what I call blind spots; particularly in individual human psychology (my own), but then progressing to blind spots in group psychology. The premise is that there are multiples of psychological processes that lead to the various strategies individuals employ, and that these processes lead to real-world aggregate social behaviors that can wander far from any semblance of rationality. Though the concept should be rather obvious, given the disastrous history of the human race, it is more readily understood when one considers the degree to which individuals are willing to believe what it seems most advantageous for them to believe–believing our own press. This phenomenon is very much related to our sense of self-identity, our fear of external judgment and the degree to which we are controlled by our egos. The forces unleashed on our behavior can reach extremes in financial markets where participants engage in zero sum exchanges of stores of value requiring real time decisions that leave no doubt as to which group are the winners and which are the losers. Because the stakes are high, market participants are notoriously flighty. It is this flightiness that has led random walk theorists to the conclusion that spontaneous market movements are without order and thereby unpredictable. Though the former is likely true, the latter is proven false by those experts that repeatedly outperform the market.

My method of conceptualizing social behavior falls within the category of fallibility, but zeros in on what I refer to as an inherent instability in mankind's self-identity. Growing into our own skin and deriving a stable view of ourselves that is not disturbed by the successes of others, or our status relative an externally derived social metric, is something that occurs later in our lives, if it occurs at all. Because the drive to better one another pushes the hawks onto each other and on to the doves, as a species we are hard wired for instability. We forever seek it, but it remains forever hidden. Even once we seem to have it, a sudden unpredictable move by our spouse, a change in job security, even the arrival of a potential competitor can throw us off again. This inherent instability on aggregate forms our collective ego and it is the collective ego that moves the invisible hand. My method of prediction, data analysis combined with organizational social psychology, seeks the shadow of that hand. To put this into more manageable terms, I seek to understand those drivers that move individuals to pursue irrational behaviors which then move markets away from equilibrium. By investigating my own blind spots, and enquiring into the psychology of others, I aim to identify the unspoken ideologies that drive group psychology; they are derived on philosophies and values in the various cultures and organizations and influence the way that markets respond to various news releases.

Because of the reflexivity between markets and real-world events, and the dynamic forces that shape responses to world news and sequential responses between players on the various stages, it is understood that the value of constructive prognostication is repeatedly subject to changing global circumstance. The feedback between market movements and real-world movements suggests that the first-best method for achieving objective success is correlated to the first-best method for achieving operational success (market success), perhaps to the magnitude that reflexive processes influence global circumstance. Therefore quantifying that magnitude is at the base of achieving both operational success and objective success. Because the reflexive process is dynamic, a sound theory that happens to be absolutely correct at the moment it is presented would on the very next moment be incorrect–bias driven by double causation. Thus theorizing, positioning, re-theorizing and repositioning stochastically, which is given to be, by and large, the successful formula for management of short and medium term funds is also, to the extent that reflexive processes influence real events, a successful formula for foresight into real economic outcomes. In other words, everything you have just read is subject to change tomorrow, not because it is incorrect, but rather because it is only a glimpse of a moment in time.

Yuri Tricys, August 14th, 2013