



Hale-Bopp Prophecies & Other Impossible Forecasts

I don't think anyone is thinking long-term now. THOMAS MANN (1875-1955)

The art of prophecy is very difficult, especially with respect to the future. MARK TWAIN (1835-1910)

We, of course, are recalling the Heaven's Gate clan of apocalyptic mystics of the mid-1990s who were making bogus long-term predictions based on the appearance of the Hale-Bopp comet. They were sorely wrong, suffering serious consequences. Why are we drawing connections to the Hale-Bopp comet? Frankly, global financial markets may presently be dependent upon a comet shower of long-term prophecies that may be just as misleading.

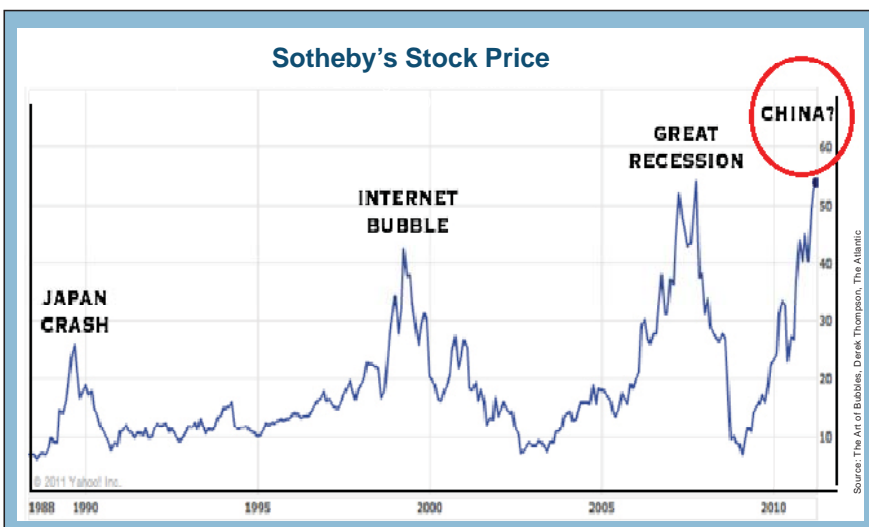
We will review just 5 of these suspect, but widely-received longterm prophecies and connect them with our current portfolio strategies. Rest assured, any Phenobarbital-laced apple pudding will be reserved for these consensus theories.

Near-term Diving Divining

Before turning to matters concerning the extreme long-term, let's first turn to more recent market developments. We observe that significant shifts are well underway. For one, as anticipated, an economic slowdown is now clearly in tow. Depending upon the outcome of current U.S. budgetary squabbles; this slowdown could yet be much steeper than most are willing to speculate about in print. We are referring here to forecasts that could involve the R-word — recession. There are also worse outcomes that certainly cannot be said to have “zero probabilities.”

Frankly, there is no shortage of wildcards that could further darken the outlook, especially for commodity producing countries. For instance, it is not improbable that China could experience a “hard landing.” In fact, we think that this will have high odds under certain scenarios, as we will explain shortly.

Summing up the post-inception GFC (Global Financial Crisis) period, virtually all the world's policymakers and monetary chieftains huffed and puffed as never before to reflate world economic growth. They have been trying to out-run past errors and the deflationary maws of deleveraging and insolvency. The recovery momentum of both economies and financial markets — whether sham or real — cannot yet be conclusively said to have



attained “escape velocity” ... certainly not for the U.S., UK, Ireland and a host of others countries.

The “rocket fuel” and “bungee chord” analogies that we have used in our commentaries of recent years are again timely to reconsider. Now, the rocket fuel is near spent; the rebounding elastic chords of inventory rebuilding and pent-up demand losing their thrust. The orbit of the rocket craft again begins its decay, drawn by the gravitational pulls of deleveraging, decelerating government stimulus and careening debt levels. Just what will supply another booster stage? We don't see it. QE3?

That brings us to the currently deteriorating “trifecta” of consensus beliefs that has driven global risk capital these past nine months (though, admittedly, a consensus that is fraying at its edges of late). Markets took full ambit to extend one-way bets on the strength of these three received shibboleths:

1. That the U.S. dollar will devalue forever against the rest of the world's currencies.
2. That non-advanced economies (and ergo their stock markets, though really these are a large number of countries with wildly varying prospects) will forever outperform the sclerotic developed world; and:
3. That commodity prices will be sure to hit the moon because the world is running out of stuff.

All of these three beliefs were mutually reinforcing, making these deductions appear deceptively logical.

This is where the Hale-Bopp comet comes in.

Hale-Bopp Prophecies

All of the aforementioned “prophecies” cannot be guaranteed to hold. Yes, the underlying genesis of these beliefs will have been based on evidence and developments at the outset. For example, it is fact that China rapidly became the world's largest producer and consumer of steel over the past two decades. It is fact that many commodity prices have soared to new all-time highs.

The point we make here is that history is not being disputed, but rather its portents. Our perspective therefore is that these consensus views are now all highly vulnerable. Why? Because they are based upon what has already happened in the past ... in other words, representing rear-view mirror gazing. They are neither sustainable developments nor trends that can be extrapolated reliably into the future.

In addition to the “trifecta,” we observe no shortage of supposedly epoch-changing forecasts that really have no

more foundation than an end-of-world prediction based on the appearance of a comet in the sky. These sweeping economic and financial predictions — prophecies that fraudulently claim to pierce the dark veil of the far, far future — are little different than the legions of other false prophecies throughout history. Certainly, their harbinger was not always the bright perussia of a new comet (Hale-Bopp was much brighter than astronomers had predicted). More usually, they were foretold by “bright” supposedly enlightened priests, self-proclaimed prophets and/or scientists of certainty.

This connects us to today. In this late, great, secular age of mass financialization and globalization, all three stations of priest/prophet/scientist can be fittingly represented by the soothsaying financial economist and the ostensibly-Midasean, wealth-creating portfolio manager. They are today's swamis and shamans. Despite the fact that the field of economics belongs to the arts (not the sciences) and that the prophecies (gazillions of financial forecasts that are frequently revised) of the latest shaman-class are entirely unreliable, if not worthless, their forecasts nonetheless remain in high demand.

Seriously, there really isn't much difference between the prophesying broker and the ancient practitioner of interpreting omens. Every shaman in history was accepted as steeped in received wisdom, knowledge and ritualistic method. They all were thought wise at the time. None ever viewed themselves as uninformed or ineffectual, though they may have been reading chicken entrails.

Yet, apparently, the “fertility gods” of financial fecundity remain auspicious for capital markets. But enough of our Bay Street divining. Consider further the prophecies being bandied about today that may qualify as candidates for Hale-Bopp infamy. They range from the apocalyptic to the improbable.

Just what Hale prophecies do we plan to Bopp?

Hale Forecast #1: China Will Continue to Boom. Will China end up being the growth story of the 21st century? Many think so. China and its massive Asian manufacturing hub are such an obvious development that it underpins one of the key millennial themes for investors around the world. There has been no shortage of economists who have “scientifically” extrapolated China's past growth surge into future supremacy and world rule. Emerging nation economies, too, will surpass the developed world and China's GDP will continue to grow at a 10% pace, outflanking the United States by 2025. Frankly, it begs the obvious, doesn't it?

We Say Do-op Bopp to That: When it comes to the received forecasts about China, we must definitely go with the Bopp. We are not convinced that China will become

the world's most powerful economy within the timeframe expected. Why? For one, the past is not prologue and China likely faces far too many structural problems

Firstly, consider the absolute massiveness of the transition that has already occurred with respect to China and the Sino-centric Asian manufacturing hub. In the case of American consumption trends, virtually every manufactured product that can be imported on a container ship is likely already made in China (if not another Asian nation). In fact, for the past two decades, America's productivity figures and "green footprint" were boosted by exporting off "dirty, commodity and labor-intensive" manufacturing capacity to Asia. Sino-made products now seemingly dominate almost every single manufacturing category other than automobiles and consumer electronics. The pivotal point? This monumental shift cannot be repeated.

Secondly, when ever before in history has a nation of 1.3 billion people gone through a transition in its residential housing stock from a 0% home-ownership rate to 60%? To make this even more improbable, let's add that this planet deforming demand impulse occurs in a space of less than two decades.

This indeed did happen in China along with massive supporting infrastructure expenditures. At this point, most major public projects have been identified.

Anecdotally, could this at least partly explain why China so suddenly became the world's biggest consumer of cement ... not to mention a host of other commodities and resources? Yes, definitely. Here again is the crucial point: This massive, compressed resource demand shock for the world will not repeat anytime soon. Yet, this "past" development underpins future forecasts of similar growth. This is both unrealistic and incredulous.

China's home ownership rate cannot again rise by 60 percentage points to 120%. In fact, the more apt question is whether there might not already exist a huge real estate bubble in China? Most likely, yes. Consider that the U.S. produced the catalytic fodder and malinvestment for the GFC with only a 4 to 5 percentage point rise in the home ownership rate (1994 to 2005). Residential investment ballooned to as high as 6.1% of GDP (now having plunged to around 2.0% or so). In the case of China, its residential spending has soared to as much as 11% of GDP, having yet to tumble. At some point (if not soon) this presages a violent decline in cement demand, not to mention a wide panopoly of commodities.

Finally (foregoing many more possible Bopps), China's structural problems are not conducive to creating a new world economic super power. Firstly, in several decades, it will already sustain the growth-depressing consequences of a fast-aging populace. Even more seriously, its chronic and severe gender imbalances augur for much darker outcomes. Societies with large, unmarried male populations do not

make for stable, world-wealth enhancing influences.

Hale Forecast #2: Emerging Markets Forever

We Say Half-Bopp: First, allow us to say that we are not iconoclastic enough to gainsay the superior growth prospects of some emerging economies over the next 20 to 50 years. Here we only quibble about the timing and the price. However, consider that emerging markets yields have already ... repeat already ... traded through advanced country sovereign yields. This represented a convergence of more than 900 basis points ... yes, 900 ... this itself being more than three times today's nominal yield of a U.S. 10-year treasury bond.

There can be no further 900 point convergence. In short, the "big valuation bang" for emerging market investing has already happened. That said, we are keeping the faith ... still inclined to believe that developing nations will continue to catch up to the living standards of the OECD nations. However, the conclusion also remains that the big growth of the past that is reflected in the current consensus cannot be validly extrapolated into the future. For now, a growth slowdown likely lies ahead ... at the very least, a period of slow economic expansion.

Hale Forecast #3: The World Will Run Out of Commodities

Bopp to That, Too: No, not anytime soon. And, yes, we do not disagree that world is running out of cheap oil. Yet, none of the "scarcity" arguments are strong enough to counteract an old-fashioned cyclical downturn or the bust of speculative bubbles. Not excluding the already-made points, there are plenty of reasons why the world is set for a more violent commodity correction than is typical of a post-WWII cycle.

At the very least, in response to higher commodity prices, we must expect changes in consumption behaviour over time. Rick Bookstaber makes this point recently (Roubini Global Economics). Observed over time, the human being is an adaptive animal capable of changing behaviour, especially so if it caters to new wants and rational expectations. Who knows to what extent such demand changes could yet range? In the meantime, supply is rapidly expanding. For one, many mines that were shuttered in the past have and are being reopened.

Wealth-driven behaviour should not be overlooked either. Viewed over time, the preference of asset types for the financial sector (both bank and non-bank) and private investor has always been fickle. By and large, they buy what went up and sell what went down. Credit institutions lend into rising asset environments; and cut credit lines into declining collateral values. Even supposedly-sophisticated asset managers and consultants try to chase or escape past performance. To wit, portfolio demand for commodities and hard assets over recent years has played a significant role in driving up commodity prices.

Moreover, hoarding and inflation-hype has further catapulted prices.

Those commodity investors that drink too long of this cocktail of Phenobarbital-laced applesauce, likely face an unpleasant and meteoric flame-out. When the commodity downturn begins in earnest, there will be plenty of sellers ... eventually. As we have already pointed out, the world has just experienced the largest shift of production capacity and resource consumption probably ever in history, China et al probably inducing the biggest usurpation shock and incremental pull on the world's commodity supplies — from copper to metallurgical coal — since possibly the ancient times of building the ziggurats.

Hale Forecast #4: An Inflationary Blow-off is Surely Underway

Again We Say Bopp: We have written much on inflation in the past and, as such, will truncate our retort to this latest consensus forthsaying. Yes, it definitely is true that QE II served to elevate inflation expectations. Indeed, there also can be discerned a late-stage cyclical effect.

However, we think that inflation channels and its manifestations are being grossly misread. Suffice it to say that there remain huge deflationary forces. Also, other forms of inflation manifestations are being entirely overlooked. For example, the cost of retirement has at least doubled over the past 5 years due to the collapse of interest rate levels. Is this not a form of inflation to the Baby Boomer demographic? Unfortunately, and crucially, it is a form of inflation that has deflationary consequences for consumption.

Hale Forecast #5: The US Dollar Will Fall to Oblivion

Actually, We Don't Know Whom to Bopp. To all the accomplished currency analysts out there, we say "Hale, Hale." As for us, our currency forecasts certainly get bopped from time to time. Frankly, over the long-term, we have no idea which currency will hit its endpoint first—the British pound, the yen, U.S. dollar or euro. It's an extremely competitive "ugly" contest. Now it's the euro; next the dollar. They all will eventually flame-out. What we need here is a real swami.

Summary Conclusions

Since late last year, we have been reducing risk. Our quarterly publication, *Portfolio Update*, details these shifts. Some of these changes proved to be early (seemingly our characteristic trait) however, are definitely on side to date. In brief,

The brave long-term forecasts (prophecies) popularly underpinning the current consensus investment views — bullish and profitable as they may appear — are not immune to disruptions.

we had raised our exposure to fixed-income to overweight; lowered equities around the globe; exited exposures to some commodities. As such, balanced global portfolios still have plenty room to generate positive returns multiple-times better than a CD (certificate of deposit) yield over the next 7-year forecast period.

At this time, we expect that a growth-slowdown is underway and may yet take some time to be fully discounted in financial market levels. This raises the risks of other potential complications, some of which have already been mentioned ... i.e. Asiatic "hard landings." (Please see the interesting China "bubble indicator" shown in the front-page graph.)

The brave forecasts (prophecies) popularly underpinning the current longterm consensus investment views — bullish and profitable as they may appear — are not immune to disruptions. No society or country has ever escaped the downside adjustments of credit-driven bubbles, no matter the divining powers of its demagogues and prophets. The foibles and consequences of funny money have a much shorter timeline of fulfillment than do long-term secular forecasts and, for that matter, the next appearance of the Hale-Bopp comet.

May we be the first to prepare Wall Street for the next cycle of Hale-Bopp prophecies. On second thought, this may not be necessary as there may be no Wall Street at that time. The next appearance of the Hale-Bopp comet is forecast to occur 2,533 years from its last showing (4385 CE). But that would count as a long-term forecast. We will pass on the Phenobarbital.

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