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SAVING HUGH HENDRY

How the Coming Bear Market in Global Sovereign Debt Will Drive Capital Back into Real Assets

Hugh Hendry is a brilliant and colorful money manager who resides in London. I don't know if Hugh has always been colorful. I do know he's always been brilliant. I first learned of Hendry while reading a copy of Barron's, way back in 2001 and 2002. At that time most investors in the US were still in hangover from the tech wreck, and continued to focus on Intel and Yahoo. But here



was Hendry sitting in a simple chair in St. James, checking London Stock Exchange quotes on a handheld, and talking about Iron Ore. Iron Ore? Yes, Iron Ore. At that time, Hugh was starting to tell a global growth story that would be very industrial in nature, and would concentrate on mining and energy. Hendry was buying European mining names that no one had cared for in decades. He was very much then, just as he is now, a heretic.

Fast forward to 2008, however, and much has changed in Hendry's view. Like others, he saw the financial debacle coming and exited many of his resource names in 2007. And then, as inflation became a cover story on the Economist magazine and elsewhere, Hendry began to buy bonds. Government bonds. US bonds. UK Gilts. German Bunds. As the bond rally unfolded, Hendry bought more. He even bought bonds in his Agricultural Fund, and started buying for his own account the UK War Bond, which is a perpetual artifact of World War I with a 3.50% coupon that has traded for much of the last few decades well below par. That bond never matures.

Now, when you are buying the UK War bond which is not terribly liquid, one obviously has a strong view about Deflation. And Hugh Hendry does indeed have a strong view about Deflation. In numerous interviews over the past 9 months, Hugh has said he sees the most terrible things coming for the global economy and especially the Western financial system. Hugh has in fact said he sees "dead people" in an allusion to his view (which others share) that a global depression could result in deprivation, starvation and possibly war.

As Gregor.us Monthly goes to press here in 2009, and UK and US financial stocks crash once again, one can only marvel at how correct Hendry has been. Many have tried to call the end of the multi-decade bull market in bonds, but here is Hendry—not a price-insensitive foreign central bank—but a money manager that correctly switched from this decade's Inflation thesis to a

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Deflation thesis when few were nimble enough to cross that divide quickly. The price move higher in UK Gilts, US Treasuries and German Bunds has been nothing less than majestic these last six months.

Now, however, the winds of change are blowing once again. Far be it from me to instruct Hugh Hendry but in the last few weeks I've started wondering if Hugh is selling his bonds. And frankly, I hope for him he is indeed selling. Over the past eight weeks with a 30 Year Treasury bond auction here, a German Bund auction there, we've started to see the flashes of a very extended market. I think we're seeing the end-game of a 27 year bull market, in government debt. And it comes, apparently, as the world tips over into stealth beggar-thy-neighbor policies, and as questions about solvency are rampant, thus affecting the credit quality of sovereign debt. If this is true it's time to save Hugh Hendry, and get him out of all his bonds.

THE 27 YEARS SINCE 1982



As 2008 passes into 2009, I cannot help be struck by the potentiality in the following four markets: US Treasuries, Commodities, Industrial Equities and The Nikkei. All four of these markets experienced a significant pivot back in 1982. US Treasuries and the Nikkei started bull markets in 1982. Commodities started a bear market. And Industrial Equities saw underperformance in relation to Financial equities, which went on a tear with the bull market in bonds. Now, 27 years later, Commodities are correcting having started a new bull market earlier this decade. Industrial

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equities are outperforming Financial equities. The Nikkei is nearly back to 1982 levels. And Treasury bonds look to be putting in a top.

This begs the question: are we at a major turning point in these four markets? We are certainly set-up, given current global conditions which are horrid, if not terrifying. If we are not at a turning point in these four markets, then the world has surely entered something close to a Depression. That's why I see this moment as very bifurcated. We either reflate now over the next 6 months, or we will endure another deflationary leg down globally in asset prices. The two possible outcomes therefore are nothing less than awesome. Let's take a look.

If the world successfully reflates, I would tip the Nikkei to make one of the most heroic and mighty moves higher that we have seen in any market in the last 100 years. The Nikkei, in my view, is a veritable proxy for global industrialism. Along with Germany, Japan is a provider of the highly engineered infrastructure equipment that the developing world started to buy, this decade. In addition, the Nikkei contains a ton of companies selling either near, at, or below book value. It's frankly looking like 1982 all over again in Tokyo. It's not often one gets a chance to buy a senior market at 27 year lows. One would simply have to target 40,000 on the Nikkei if such a bull market returned. And this would obviously pull along industrial equities from nearly every country in the world.



Meanwhile, the strong possibility that US Treasuries are at a 27 year high is the perfect counterpoint to the Nikkei. The chart of the 30 Year bond is a picture of order for nearly 26 years.

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And then in the last six months it went parabolic. That is a huge technical warning that fits beautifully with current conditions: a FED on a reflationary warpath and a Treasury issuing supply like there's no tomorrow. The surprise, in all this, is that the world would probably be able to handle a bear market in US Treasuries much better than if the bull market in US Treasuries continued, *on the back of further deflation*. In fact, let me explain the problem for US Treasuries, if the world deflates further, from here...

THE PROBLEMATIC THESIS OF US EXCEPTIONALISM

What baffles me about the US Treasury bond bulls is that they think the private economy and the private banking system of the US can collapse, but that the system of public government will be fine and should be bought. It's clear to me that US Treasury bond bulls are using the Japan collapse analog, post 1990, and they are thinking of a deflation trade where they ride the US 10 Year Note to a yield of 0.50%. Between here and 0.50% they may actually be proved correct. However, in such a scenario the US private banking system would detonate (if it is not already) and there would frankly be no way to service the interest payments on US Treasuries in a world where the US economy has collapsed. Although I began to write and talk about this phenomenon several months ago on my blog, we have not had a real world example of such an outcome *until just the past two weeks, in the United Kingdom*.

The situation with the UK banking system illustrates perfectly how the global foreign exchange markets and global bond markets can finally start to penalize a country's sovereign debt and currency, for severe troubles in its banking system. This week, Royal Bank of Scotland reported a loss equal to 2.00% of UK GDP. It is further said that the balance sheet of RBS is as large as the entire UK GDP. Accordingly, Pound Sterling got whacked this week and so did UK Gilts. Now do you see why I am trying to save Hugh Hendry? You know, Hugh with his UK War Bonds?

The deflationist bond bulls believe in a sustainable bull market in Treasuries, even as Treasuries are printed into the stratosphere and as our own banking system and large money center banks crater, just as they are in the UK. *As I said, the Japan analog is clearly the talismanic story for this trade.*

But the problem is that the position the US occupies in 2009 is nothing like the position Japan occupied in 1990. Firstly, although Americans have just started to save again, as a country we still have little to no net savings. And how much saving can we do as a group with unemployment rising? So, there are no savings as yet backing the USD in the same way Japanese savings backed Yen in their lost decade. Second, the United States is not a manufacturing and exporting powerhouse, selling lots of finished products into a relatively healthy world economy the way Japan was able to do in the 1990's. People have clearly forgotten that the world was more decoupled back then. Japan entered deflation, but, was still able to export into a functioning world economy. That's just not the case today. Finally, the US government already is having to monetize US treasuries and US MBS. And we haven't even seen the total collapse yet of the US banking system, and unemployment is not at 20%. How much will we be monetizing then?

People truly believe the US government can service US Treasuries in a new US depression? Not a chance. The best the US Government would be able to do is print up money for rollovers and interest payments. Anyone who is still holding USTs at that point will be willing to accept confetti, and, *the mockery* that comes with monetization. The bottom line is that if someone tried to make the case that you could ride German Bunds all the way to a zero yield as the German economy

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totally collapsed and that German Bunds would maintain and even increase their purchasing power because of "deflation" you would just laugh at that person. The UK is no different, as this week's events have shown. And the US is no different. We are not exceptional.

THE BOND MARKET'S FATE

What Hugh Hendry and other bond bulls must understand (by the way I am only interested in saving Hugh because I like him. All the other bond bulls can crash along with bonds), is that regardless of whether the world reflates, or deflates, sovereign bonds are fated to enter a bear market. And this gets us back to the Nikkei, Industrial equities, and Commodities. Obviously the simplest reason these three market would benefit from pain in the bond market is the world's capital is currently crowded into cash, and bonds. Just as one would expect at the end of a 27 year bull market entering its final days, the rushing-in has occurred most especially in the last 9 months. Global bond markets are putting in a spectacular blow-off top befitting to their multi-decade run. To those who have caught this final move, I tip my cap. But since such a large portion of the deflationary and safety trade thesis has already come true, is it really wise to stay hiding in US Treasuries, until they meet their fate? Even Hendry has said that once yields on government bonds get very, very small and he sees an end to the Deflationary spell, he will switch and buy Gold and Oil. I say: *Hugh, that time draws near and sooner than you originally anticipated.*

THE TIDAL WAVE OF CAPITAL

Accordingly, there is a whiff of reflation in the air even in the midst of this deflationary storm, as Money itself starts to become a problem. Gold, Silver, and even Oil are looking like stores of value as the first signs of trouble in senior sovereign debt emerge from the UK. Europe sovereign debt and US sovereign debt is next. As I have written on my blog and elsewhere, it is a myth that the US is exceptional or that "we will be badly off, but the world will be worse off." This week's action in the shares of our largest money center and custodial banks should have put an end to this US - centric passing fantasy. I find it ironic but perfect that Niall Ferguson, who is a believer in American Exceptionalism, is recently out with his book *The Ascent of Money*, at a time we are about to witness *the descent of money*.

Obviously if the world deflates from here there will be no monstrous Nikkei rally from 27 year lows. Global industrial equities—even the good ones—will run into trouble, and Commodities not as a group but many commodities will do poorly, base metals especially. But in a new deflationary leg down, while sovereign bonds may go a tad further, but they too will get crushed. And then there will only be Gold, Silver, and possibly Oil. In deed oil, especially from these levels, is now looking like a low-risk store of value. At .90 cents a gallon, it's also one of the cheapest liquids and frankly one of the cheapest assets in the world. As I have written on my blog, oil at current prices is essentially free, as nearly 40.00% of the world's oil cannot be economically pulled from ground at prices in the 30's. With non-OPEC supply getting crushed from both depletion and price it is time to consider oil not so much as Money, but, oil as a way to protect a portion of one's wealth in a world newly beset by risk in senior sovereign debt, and currencies.

--Gregor Macdonald, 23 January 2009

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Supply Data Review

For most recently available data through October 2008

Gregor.us Monthly uses the Crude Oil Only category to analyze global supply, as provided by [EIA Washington](#). The reason is simple. The All Liquids category(ies) provided by both IEA Paris and EIA Washington include 15% Natural Gas Liquids, and Biofuels. As such, the All Liquids measure no longer gives an accurate picture of oil.

October: Non-OPEC supply rebounded in October by nearly a 1 Mb/day after hurricane shut-ins came back on stream. OPEC supply remained flat. Thus, global supply was back up to August levels at 73.826 Mb/day. This remains below the 2008 production peak of 74.835 Mb/day in July.

If you're concerned about price in 2009, then prepare for price to be largely influenced by the build in OPEC spare capacity. Offsetting this are the large declines in non-OPEC supply. Cuts from OPEC are of course voluntary and represent supply that could come back to market either easily, or somewhat easily. Cuts in non-OPEC supply are also voluntary but are driven by the economics of a much higher cost barrel of crude. That supply will not return so easily.

At this time, I estimate that 40% of the world's oil supply cannot be profitably lifted when oil prices are in the 30's. Much of that supply is in non-OPEC. This is conservative compared to some analysts, who think as much as half of the world's supply cannot be profitably lifted for less than 60.00 dollars a barrel. We shall find out exactly how this operates during the current period, however, as current prices make for a great test case of price's effect on high-cost supply.

I maintain my forecast that the world could lose 8.00% of non-OPEC supply by Summer of 2009, dropping well below the six year average of 40.5 Mb/day to 37.00 Mb/day. While we may not get quite that low by mid-Summer, we should easily hit 38.00 Mb/day by June. Even though non-OPEC supply rebounded in October by nearly a 1 Mb/day after hurricane shut-ins came back on stream, I do not expect this rebound to survive declines elsewhere in non-OPEC that have come through December. Mexico is in terrible shape. And the North Sea is not doing well. Often ignored, the United States saw production slip below 5 Mb/day in the last two months. While the large platform Thunderhorse has come back on line, the aggregate loss of myriad small wells across the United States is going to take its toll on supply. Five years of steadily higher prices did a lot to bring small operator supply on line. Ultra low prices are having the reverse effect. No surprise.

2008 non-OPEC supply through October currently averages out to 40.324 Mb/day. Again, the analytical job now in supply is to concentrate almost exclusively on non-OPEC. OPEC cuts are

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orderly, and for the most part well-calibrated. There is no mystery to solve right now in OPEC supply.

2008 non-OPEC Month by Month Production in Mb/day

40.689 January
40.708 February
40.599 March
40.465 April
40.519 May
40.372 June
40.739 July
39.702 August
39.152 September
40.299 October

40.324 Mb/day average

In the World category global total production was raised only by the amount of non-OPEC's rebound . Thus, we remain within the averages of 2007, 2006, and 2005.

World Total Production in Mb/day through October 2008

73.737 2005
73.461 2006
73.015 2007
73.936 2008
