



Money (That's What I Want)*

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"Money only appeals to selfishness and irresistibly invites abuse."

Albert Einstein

The same is obviously also true for "fiat money", money supplied by the central banks which is not backed by assets. In this case, monetary policy demands the utmost discipline in order not to be misused for anything other than purposes serving to stabilise monetary value.***

After concerns about inflation and deflation alternated until the beginning of this year, the fear of deflation has heavily increased in recent weeks. This was triggered by signals which indicated the danger of an unsustainable economic recovery with a view to government finances getting out of hand. Deflation is a phenomenon which has historically occurred extremely rarely and the economic interactions of which are far less clear than generally assumed. In this article we attempt to derive the triggers and interdependencies of deflationary tendencies on the economy, with the key question of how deflation can even occur in an environment of extremely inflationary monetary policy. We hope you will forgive us for briefly digressing on the tedious theory of deflation, but in this case the journey is the reward.

I. A brief history of deflation

Deflation is generally understood to be "a general decline in the prices of goods", although there are many more forms it can take than is commonly realised.

Market segmentation and "good" deflation

Obviously there are always certain market segments in a national economy in which prices tend to decline. That even makes sense, for example, when technical progress contributes to efficiently replacing obsolete technologies and products. At least since the oil catastrophe caused by BP, the price of vehicles with high fuel consumption rates can be expected to drop compared to those of more economic models, which in turn may well be reflected in the falling prices of SUVs. This is a phenomenon which has been observed in the States for

years and which US government incentives to buyers has only temporarily reined in.

Depending on the production structure of the automobile industry, this substitution effect can also result in a decline in average car prices, which ultimately results in an adjustment in industrial production and is thus a welcome phenomenon. If a number of industries relevant to measuring price development happen to be in just such a process, deflationary tendencies as defined above may result.

Is deflation a global phenomenon?

The same argument can be applied not only to industries but also to individual countries. A country whose production of goods is strongly dominated by industries facing a price decline might exhibit deflationary tendencies without any talk of a global price decline. In open economies, a corrective mechanism would then be generated by rising foreign demand.

The current situation deviates however in some significant ways from the aforementioned ideal development. Strongly diverging economic developments in different parts of the world, increasing imbalances in foreign trade and differing monetary policy measures of national central banks (interest rate hikes in Canada et al.) clearly indicate that deflation will not be a primarily global phenomenon but that it could occur in a significant number of western economies.

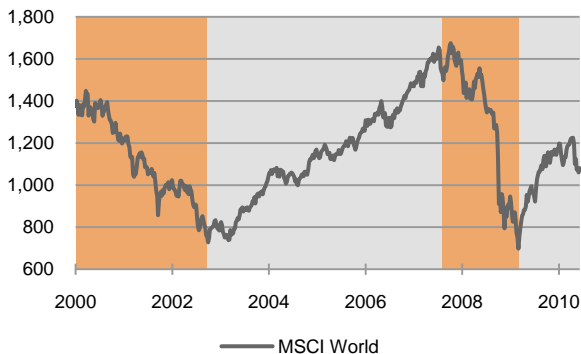
Deflation in price of goods and assets

Without going into the fundamental problem of measuring price development (who really buys the basket of goods?), an amazing misinterpretation is nonetheless rather obvious. Measuring inflation focuses on the prices of goods in the real economy and this in a national economy, which is increasingly dominated by the development of the financial markets.

We have already dealt with this problem in many earlier issues of our newsletter in which we wrote about the ignorance of central banks in considering the inflation of assets. The same also happens of course in the case of asset deflation. Considering the development of the global equities markets since 2000, it is quite reasonable to assume that there were several deflationary phases; otherwise they would obviously be higher.



Inflation, deflation or just plain volatility?



Orange shaded area: Deflationary development
 Grey shaded area: Inflationary development
 Source: Bloomberg

From the investor's point of view, however, it is obviously the price development of assets which is key and there is no denying the fact that a) different price developments may result on the goods and financial markets, b) the interdependencies between the goods and financial markets are ignored by monetary policy decision-makers (to which the government itself must also be added, at least since the ECB's bond purchase programme), and c) the question of governmental support packages for the financial sector appears in a completely different light.

How does deflation come about?

Ultimately, in real economic terms, deflation is traditionally understood to occur when a decline in demand for goods results in the price of said goods also falling, or in monetary terms, a shortening in the money supply via a variety of mechanisms causing the same effect. The following reasons seem to be more or less relevant against the current backdrop:

1. Reluctance to spend

One reason for inflation that is stated in theory again and again is reluctance in spending and investment. It is precisely the tax increases that are under discussion at the moment as well as a dampened outlook on economic growth that are key factors here, with major significance given to American consumers, who have been highly praised over the last decade. US consumption not only maintained US economic growth at a high level but also growth in Asia in particular (predominantly China). The death of the American consumer has often been declared, however he has continued to remain steadfast when it comes to opening up his wallet. Is this time any different? There are reasons to believe so. The Ameri-

can budget situation (both government and private sector) is already at a level which has caused the rating agencies to prick up their ears, and only the fact that the US printing presses are kept churning at a high speed supports the thesis that US consumption is defying the current crisis as it has others. The discussion on easy money policy options has its limits, however, and we will discuss these later on. It is nonetheless obvious that only the tremendous action taken by the government via a variety of measures (TARP, CARS ("cash for clunkers") etc.) kept the US economy afloat in 2009.

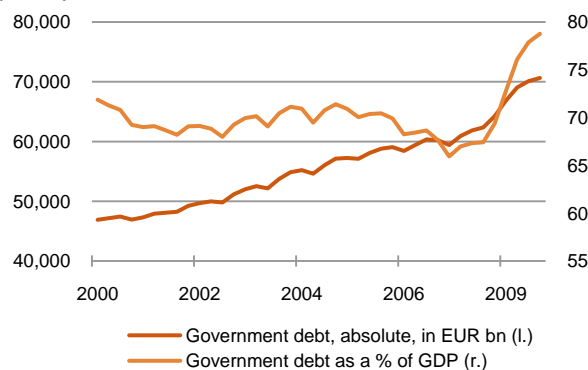
At least expecting the American consumer to compensate for a slowdown in government spending on top of everything else seems overly optimistic. Mainly because all hopes for global growth seem to be limited to China – and there are decent arguments in favour of this – but a certain concentration risk due to macroeconomic variables has to be taken into account. If it weren't for China, one would most likely have to assume dampened expectations about the global economy not only in the USA.

Conclusion: Deflationary trend

2. Reduction in government spending

A reduction in government spending naturally has a dampening effect on prices. The current situation of government budgets in Europe, the UK and the USA (to name only the most important areas) allows for no other measures except a reduction in government spending to a level compatible with the Maastricht Treaty criteria as well as criteria set by the rating agencies. This is compounded by the fact that tax increases will also be necessary. Direct consumption taxes immediately result in decreased demand while indirect taxes impact disposable income. Both result in a further drop in demand and thus in falling prices on the goods markets.

Rise in government debt in the euro zone since 2000 (EU 16)



Source: Eurostat

Conclusion: Deflationary trend



3. Asset deflation and credit deflation

The problem of asset deflation was already mentioned above. If private households lose some of their assets on the financial markets, this reduces their disposable income, which in turn is partly reflected in decreasing demand for goods. The US real estate excess was financed through low interest rates as well as through American households accumulating additional assets on the capital markets, enabling them to live beyond their means. Now, of course, it is not so easy to calculate the net worth effect without knowing the precise allocation of individuals.

At any rate it is clear that the current situation on the stock markets will have rather disadvantageous effects on the demand for real goods as well. The same applies to a lesser extent to the credit markets. The price of government bonds is being maintained at an artificially high level through low interest rates (at this point we refrain from criticising the ECB's government bond purchases yet again), with commodity markets and cash substitutes (especially gold) indeed indicating asset growth in private households.

A key point however is that precisely those global financial market segments which increase in value are the ones in which people are not investing, if they really trust in the economic recovery of the global economy. Those who have invested a large portion of their money in gold have most likely done so not increase their spending in the future but to preserve their capital. The potential of reduced lending from banks to companies has already been discussed at length (also by us).

The need for a large number of companies to tap the capital market in order to refinance expiring bank facilities can already be observed at a global level. April 2010 was the strongest month for new issues volume in the euro-denominated corporate bond market since its inception. A decrease in lending (to private households as well as to companies) is, in turn, strongly related to monetary policy; thus at least stagnation in the real economy's credit supply (if you believe the most positive statistics) must indeed be considered a threat in view of an excessive money supply in the banking system.

Conclusion: Clear deflationary trend

Background: The possibilities of concealing asset deflation

The question of asset deflation is inevitably linked to a discussion of the most recent events involving bonds from Europe's peripheral countries. For example, looking at the outstanding volume of Greek bonds totalling approximately USD 300 bn, which were originally purchased by a wide variety of investor groups at a price

of 100, there was an estimated loss of USD 75 bn before the support measures kicked in (assuming an average price decline of 25% over all maturities).

Of course, this loss was, for the most part, not reported on the market. In cover pools, guarantee assets and bank balance sheets, these bonds can continue to be valued at 100 (which we do not want to question at this point). Even no direct loss results, the indirect costs are of course staggering, since a decrease in the price of the bonds results in a decline in collateral value, an increase in risk capital and limited ability to act for many institutions relevant for the financial market to function.

If the ECB now takes supportive action, the problem will only be solved temporarily as the losses expected still remain high. The risk remains high that Greece can only be saved by restructuring, which will necessarily be accompanied by losses for the bondholders. And that is in fact what is noticeable on the CDS market, which despite regulatory intervention continues factor in a high risk that these losses will occur. The ECB can of course buy back all Greek bonds at 100 or the EU along with the IMF can provide sufficient bailout money for servicing and redeeming the bonds. The loss would then just be shifted from the balance sheets of investors (banks, insurance companies, pension funds, etc.) to those of governments and ultimately those of private households.

An attempt to stabilise market prices through direct intervention measures was made not that long ago by the US Federal Reserve, by directly intervening in the US ABS markets, for example, and giving banks the opportunity to book certain investments in hold-to-maturity accounts. That however does not change the fact in economic terms that these investments can lose a huge amount of value. Investors would be forced to realise their losses at the latest when the issuer defaults. And the implicit default risk of Greece in mid-June remains just under 50% (5Y CDS @ 750, recovery rate @ 40%).

4. Wage deflation

A decline in wages automatically results in a decline in purchasing power and a decrease in demand causes prices to fall. At a national level, this issue results in tragic developments and has been a central point in the western world's debate on justice. It must unfortunately be stated (from the West's point of view) that this development is completely normal given increasing globalisation tendencies, as more and more production sites are being moved to low-wage countries. In times of growth, however, cheap labour can actually be substituted by more expensive labour (assuming technical progress of industrialised countries). But particularly the importance of China to global growth is a double-edged



sword in this matter. The more China can produce itself, the less it will be prepared to pay western wage standards through imports. Chinese growth should be understood as part "additive" and also as part "substitutive". This means that an increasing importance of China in terms of demand on western goods markets not only causes prices to rise, but can also trigger or strengthen deflationary trends via wage deflation in the export countries.

Conclusion: Deflationary trend

5. Imported deflation

When the dollar appreciates against the euro, foreign products become more expensive; this leads to imported inflation. The euro's weakness is obviously an argument against imported deflationary trends and a certain corrective to the aforementioned developments. However, in order to quantify the effect of net exports on the risk of deflation in a specific country, knowledge of the country's structure is a necessary precondition. Imported prices are obviously irrelevant in EEMU countries' trade amongst themselves, while imports from low-wage countries tend to promote deflation. Imported deflation however is only of major importance in the event of a global economic crisis, although we are not in a position to provide a qualified comment on the probability of this.

Conclusion: Deflationary trend

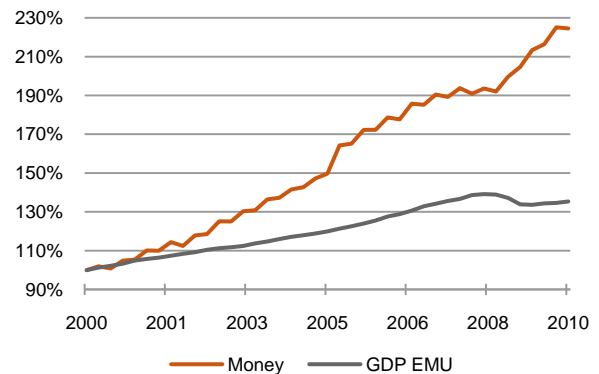
6. Monetary causes

A very central point to the discussion on deflation. If the central bank reduces money supply, this inevitably generates deflationary trends even if the implementation of this policy and above all its scope are key to whether deflation "only" appears on the financial markets or also on the goods markets. A decrease in the money in circulation has direct consequences on the money supply of the real economy as well as on banks' lending (see above). And now the story gets interesting:

a) Fiat money

What role does fiat money, i.e., the central bank money supply that is not backed by real assets, play in all this? Theoretically, abandoning the gold standard to benefit a liquidity supply not backed by assets has many advantages as monetary policy measures can be implemented for economic policy in a more targeted manner. However, the past few years have shown that more and more liquidity has to be provided in order to generate growth.

Liquidity and economic growth in the EEMU



Source: Eurostat; Bloomberg

The chart shows in a simple way the gap between growth in money supply and growth of the real economy, which has increasingly widened in the last few years.

Experience from the global economic crisis and those of Japan for more than 20 years now have caused politicians to view restrictive monetary policy as the real evil, above all in crisis situations. Even if we were to accept this argument, it is still difficult to deny that this policy is conducive to the emergence of crises.

b) Use of liquidity

It is of particular importance how the liquidity provided is used! At least since the reaction of the central banks to the impact of the technology bubble at the beginning of the millennium, monetary policy aimed at inflating assets has become the latest fashion. With his lax monetary policy, Greenspan temporarily limited such effects, only to steer later into a crisis with a much worse scope caused at least in part by this policy – the subprime crisis. Combating this crisis with excessive provision of liquidity caused a huge increase in public debt, the consequences of which have now materialised in the euro crisis. This thus begs the question of whether the obviously unlimited provision of liquidity also ultimately means that the marginal utility (in units of economic growth) of the next unit of money always has to be positive.

If this is not the case, a further increase in money supply cannot prevent deflation!

c) Speculative bubbles or deflation!

That is exactly the problem we are facing. While we often connect the massive general decline in prices across broad goods and service supplies ("classical deflation") predominantly with the development during the period of the global economic crisis around 1930 and with the development in Japan since the 1990s, it is



often said that this can no longer happen in the same way in an environment of inflated monetary supply. In this respect, the special characteristics of these developments need to be put in a current context. Fiat money requires an extremely disciplined monetary policy, which does not yield to the temptation to provide excessive liquidity in times of crisis in order to realise political goals. As soon as monetary stability is sacrificed in order to prevent adjustments that are economically necessary, a central bank is misusing the opportunities fiat money provides. When growth is solely based on the provision of additional liquidity, this results in a decoupling of the financial markets from the real economy and that is exactly the problem the western world is currently facing.

To believe that Greece and Dubai will remain exceptions may possibly be too optimistic; recent developments in Hungary and Spain seem to confirm this. Too many countries have succumbed to the possibilities of infinite liquidity; unfortunately this group includes all relevant western industrialised nations as well, with the USA leading the pack. This not only applies at the macro-economic level but can be applied to individual economic agents as well. If banks that have managed their money badly and according to the rules of the market game have no right to survive are kept alive with more cheap money, this will only increase the discrepancy between the fundamental value of the bank and its activity on the capital market.

And you certainly don't have to be an extreme liberal to see that the long-term effect of this policy is fatal in national economic terms. Sustaining the activity of a bank that is incapable of upholding market forces (or more simply put, cannot adequately meet the market demand for financial services) does not result in a collapse of the markets but in a socialisation of losses after profits have first been privatised. At this point we would like to point out that this picture does not include any political factors but is only constructed based on the economic consequence of fiat money being misused in the banking sector.

Ultimately, due to the prevailing notion of unlimited liquidity, the world no longer has the chance to decide between a crisis or a moderate adjustment path to a new balance in economic growth but on whether or not to continue promoting speculative bubbles with all the consequences that entails or drastically reducing the amount of money with all its negative consequences.

In this situation there is no simple solution; at the end of the day, we face the question of whether we want to live with speculative bubbles or deflation.

Conclusion: Possible deflation trigger

Deflation's conservation of momentum and the potential effects

The fears associated with deflation are based on the historical observation that a strong deflationary trend develops a certain propensity to persist, or can even have a self-sustaining effect. The buzz phrase "deflation spiral" describes the mechanism by which declining prices result in a noticeable reticence on the part of consumers expecting prices to continue to fall. The lower demand results ultimately in a decrease in production capacity utilisation, whereby supply-side price pressure is generated in turn. This downward spiral can develop great momentum of its own in a closed economy or in a global economic crisis (otherwise, the effect of foreign demand described above has a mitigating effect).

The effects of deflation can in theory be simply viewed as diametrically opposed to those of inflation. Pure deflation in the price of goods creates a disadvantage for the debtor, who has invested capital in real assets while the creditor benefits from his capital's constantly rising purchasing power. Unfortunately, it is not quite so easy in practice because the relative deflation rates between goods and financial markets are ultimately relevant. If deflation of assets is greater than the price decline on the goods markets, debt-financed consumption may be economically preferable.

The main problem is that deflationary momentum has sustained effects on the real economy and the financial system, as it is difficult to employ short-term political measures to counteract a process triggered by deflation since such measures involve a time lag. The financial system remains affected by deflationary momentum for a long time.

II. Impacts on companies and markets

A variety of effects may result depending on where and to what extent deflationary trends occur. Our working hypothesis is based on the following assumptions:

1. Consolidation of public budgets in the western world creates deflationary pressure.
2. We are dealing with a global decline in growth.
3. There will be deflation of asset and goods prices, with the former more pronounced.

From the point of view of manufacturing companies, deflation in goods prices leads, via a slowdown in demand, to a decline in production capacity utilisation and thus to declining sales, which, when all is said and done, will have a negative impact on earnings. As shown above, the debtor who has borrowed money to invest in fixed assets also suffers, which is then reflected in



increasing refinancing costs for companies. Given assumption no. 3, creditors will be extremely cautious in lending; the same applies to banks. Companies will thus be burdened by both goods and asset deflation and, in our scenario, are thus among the main losers.

There may well be even more fatal consequences for banks as they are particularly hard hit by asset deflation. The effects are of course closely related to a business division's strategic focus; the simple assumption can be made that investment banks in particular will suffer under asset price deflation.

Naturally, benefits can also be derived from deflation, as it accelerates necessary adjustment processes. In line with Schumpeter's economic theory, the deflationary scenario described above results in business models that are not sustainable being the first ones squeezed out of the market - the number of which greatly increased in recent years with the availability of cheap money.

What does this mean for the lending markets?

In a deflationary scenario, lending markets would come under fire from several directions:

1. The fundamental situation of most companies would deteriorate.
2. This also applies to their refinancing situation on the market.
3. Very high new issue premiums have to be paid on the primary market as demand for credit risk will drastically fall.
4. Banks will also be very cautious about lending.
5. Countries reduce their demand and possibly react with higher tax burdens for companies.

The only positive news from the point of view of bondholders is that shareholders should fare even worse, and so at least negative reallocation effects should be avoidable.

III. Ten suggestions in line with Pareto's Principle

In recent newsletters, our discussion involved more or less clever commentaries on why the measures in place do not constitute the right response to economically address the current situation in a reasonable fashion. It is easy to voice criticism but better to make construction suggestions. Here are ten measures that would stabilise the European financial market even if that would mean high costs for the system in the short term:

1. Abide by "no bailout" clauses in all cases at all levels, since the bailouts in recent years have led to nothing other than more crises and more bailouts.
2. A more restrictive monetary policy as the marginal utility of an additional unit of money is already negative.
 - Interest rate increase
 - Stop purchasing bonds
3. Take asset inflation into account when managing the money supply.
4. Withdraw all state guarantees for banks including reformation of the banking sector, in which the government is heavily involved.
5. Withdraw all state guarantees for banks including reformation of the banking sector, in which the government is heavily involved.
6. Create supranational authorities with the same powers as national ones
 - to set framework conditions for the international financial market,
 - in order to prevent national competition policy in the financial sector.
7. No protection of equity in case of crises to eliminate the problems of privatised profits with socialised losses.
8. Create an incentive system for all financial market players to ensure that when risks are assumed, losses have to be assumed along with them. This also applies to bond investors.
9. Get rid of ratings as a regulatory criterion (or for guarantee assets or regulatory capital).
10. Strengthening regulatory authorities, which should supervise less, but more effectively in the future.

These suggestions should be viewed as making economic sense - something that of course should not be confused with what is politically viable. In considering the above one would also have to accept deflationary processes – however the system's sensitivity to crisis would drastically decline in the long term!

IV. Recommendations

Tactical and strategic considerations

The negative headlines on the problem of public deficits will continue during the next few months as the solution to the underlying problem has moved far into the distance. The parallel to combating the subprime crisis is clear: Once again, we are treating the symptoms (ban on naked CDS), while only half-heartedly addressing the



true causes of the euro crisis as political resistance seems insurmountable.

How to position your company in this environment? In our opinion there are clear parallels between 2010 and 2007 – the stock market ignored what was already obvious on the credit markets for a long time then too. This explains why prices on the stock market are not far from the annual highs, while credit spreads have already significantly expanded. It is difficult to say when the next sell-off on the stock markets will be ("too many bears spoil the short"), but the probability of it occurring is high. The current spread level may appear attractive from carry aspects in the short term; however the risks clearly dominate in the medium term! We continue to favour the shorts in the market!

Forecast Table

	1 – 3 m	3 – 6 m	12 – 24 m
iTraxx Main	-/o	-	-
iTraxx Fin	-	--	-
iTraxx X-Over	-	--	--
iTraxx SovX	-	--	--
EUR HG Cash	-/o	-	-
EUR HY Cash	-	--	--
Credit Basis	o/+	+	++
Senior-Tranchen	o/+	+	++

Conclusion: If asset price deflation should turn out to be more pronounced than that of goods, we feel it is economically sensible to follow George Best's investment strategy: "I spent a lot of my money on booze, women and fast cars... the rest I just squandered."

* The original is by Barrett Strong; the Beatles popularised it in Europe; the best version to listen to is the one by The Sonics (the first punk band in the world!): "The best things in life are free/But you can keep 'em for the birds and bees".

** **Fiat Money** is credit money which the issuer is not obligated to redeem in currency and the acceptance of which is established and guaranteed by legal decree – as the explanation of legal tender. The term derives from the Latin *fiat*, meaning "let it be done". Fiat money becomes money by a country's legislative body declaring it as such. Today's central bank money, such as the euro or the dollar, is fiat money. Source: Wikipedia



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