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Do Asset Markets Really Provide Lifetime Buying Opportunities?

> "The surest way to ruin a man who doesn't know how to handle money is to give him some."

George Bernard Shaw
(musing about Ben Bernanke)

INTRODUCTION

In early 1973, I had the good fortune to be invited by White Weld & Co. Inc., the investment bank I worked for at the time, to move to Asia in order to develop principally its Japanese institutional business out of Hong Kong. White Weld, being a "high-class joint" and a "gentlemen's firm", generously offered to send me to Asia for an initial period of three weeks so that I might look around and be sure that I would feel comfortable in what would be for me a totally new environment. So, I spent a day in Tokyo and two days in Hong Kong, where White Weld had not one but two offices because the Cantonese manager who covered Cantonese accounts didn't get along with White Weld's Shanghainese staff, who had moved from Shanghai to Hong Kong upon the Communist takeover of China in 1949. The idea was that under the influence of a good Swiss manager, the two offices would be merged into a single office and White Weld's Hong Kong operations would be streamlined and more cost effective. This was the logical thing to do, and so after two days in Hong Kong I went to Pattaya for two weeks. Needless to say, after spending two weeks in Thailand I was very certain that I liked Asia. Nevertheless, I emphasised to White Weld the hardships involved in my moving to Asia in order to secure a favourable compensation package. (I still took a pay cut, but I felt that this was compensated for by the opportunity to live a challenging and interesting life and to build a business based in Hong Kong.) So, in the summer of 1973 I moved to Hong Kong with three suitcases.

That year and the following one were disastrous years for equities. From the market's peak in January 1973 to its low in December 1974, the Dow declined by 50% and Hong Kong's Hang Seng Index fell from 1,700 to 150 points. The Japanese institutional business also proved to be a total waste of time, because at the time Japanese financial institutions could invest only one million dollars a year overseas. The saving grace, however, was that Japanese brokers still had huge expense accounts and were always very keen to take me to nightclubs, etc. — invitations that, being polite, I obviously couldn't decline.

On my monthly trips to Japan from Hong Kong, I began to stop over in other countries such as Taiwan, Thailand, the Philippines, and South Korea, partly because I was interested in these countries' economies (and night life) and partly because I realised that the big money in the investment business in Asia lay in acquiring wealthy private clients. In 1974, during my first visit to South Korea, I met the top Korean business families through my friend Peter Sulzer, whose family then still controlled Sulzer — at the time, a world leader in the manufacture of ship engines and textile machines. In the 1970s, South Korea was still ruled by the military and was extremely poor. Curfews were in place, and there were no foreign investors because it was illegal for foreigners to invest there unless they had permanent residency in South Korea. However, I felt that both South Korea and Taiwan would go through a phase of strong economic growth similar to what Japan had embarked upon, and so in 1978 I began to buy shares there using the name of a Korean friend of mine (Mr. Kim). At about the same time I began to invest in Taiwan, where it was also illegal for foreigners to buy shares. When people asked me how I would ever get my money out of these countries, I usually responded that I had no intention of ever selling my shares there because I was convinced of the extremely favourable economic potential of these countries.

After a brief boom in the late 1970s, which was driven by Korean construction companies having obtained huge orders in the Middle East, the stock market collapsed in the early 1980s when oil prices no longer increased and the Middle Eastern economies slumped. However, after 1985 both the Taiwanese and South Korean markets went ballistic, driven both by the Japanese bull market and the relaxation of foreign exchange controls, which permitted limited participation of foreign investors. (Between 1984 and 1990 the Korean stock market increased 10-fold and the Taiwanese market over 20-fold.) Then in 1989 and early 1990, I became extremely negative about the outlook for Japanese stocks and the overheated markets of Taiwan and South Korea, and liquidated most of my portfolio holdings in these countries. For sentimental reasons, and also because I still believed in the long-term economic potential of

South Korea, I kept some cash worth at the time about US$150,000. (Mr. Kim, who had some legal issues, had by then transferred my account into that of a friend of his — another Mr. Kim, or "Kim2".) Then, in 1997, came the Asian crisis! Mr. Kim informed me that Kim2 also had some financial problems and that the account was basically frozen. But to my great surprise, two years later, Kim2 paid back all the funds I had invested with him, although I'm sure that he was still struggling in business.

I have mentioned this for two reasons. First, in the 1970s and 1980s, Koreans didn't enjoy the best reputation in business in terms of integrity. In fact, a late Shanghainese friend of mine — a larger-than-life figure who in the 1980s was the largest individual investor in Japan (having lived and invested in Japan since the 1950s, he had made a fortune in the Japanese stock market — that is, until 1989) and who did a lot of trading business with Korea — always warned me that Koreans would try to cheat me. But, obviously, that wasn't my experience. So, although I tend to believe that most of my readers will remember 2008 as a year when they will think along the lines of Ludwig Wittgenstein, who said: "I don't know why we are here, but I'm pretty sure that it is not in order to enjoy ourselves", I'm sure that there were also some bright spots in their lives.

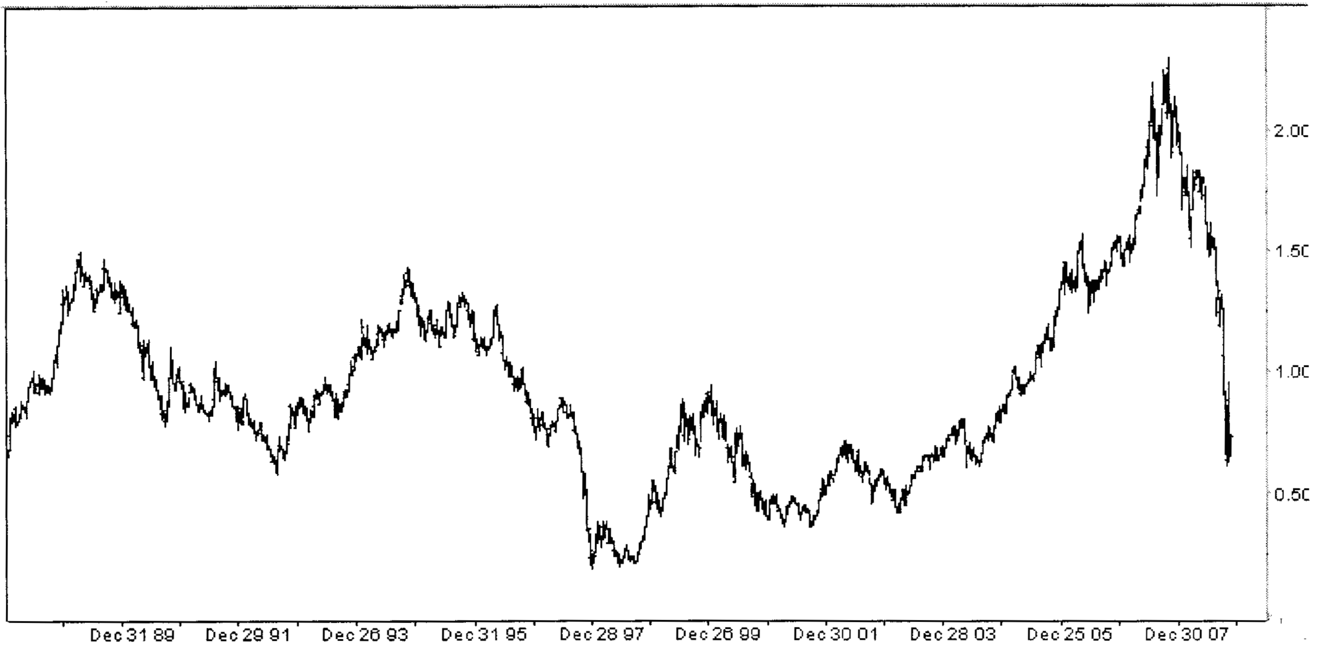
Personally, I had a wonderful year. I met numerous readers of this report and enjoyed their company, since all of them have fiercely independent minds, are inquisitive, and also enjoy a drink or two, or even three. One of them (a private investor) sent a cheque for US$50,000 to Childsdream (www.childsdream.org) after reading in this report about the flooding that occurred in Burma earlier in the year. Another reader gave me a gold coin, and yet another gave me a voucher for my daughter to shop at his luxury fashion boutique. These were all very kind and unexpected gestures, which — aside from the donation for the Burmese refuges — were also unnecessary. Another reader of this letter invited me to a seminar in Vienna where he owns the Palace Coburg hotel (www.coburg.at). He was gracious enough also to welcome my family, and we spent three marvellous days in the most stunning suites I have ever seen (not that I have seen that many). I also saw two new places in 2008: Syria, about which I have written; and Rosario, in Argentina, to which I was invited by the financial services group Rosental. I have to confess that I had never heard of Rosario, despite it being Argentina's second-largest city and the birthplace of Che Guevara. It is a beautiful city situated on the Parana River; hence its importance as a transportation hub for grains. During the day the city is a bit sleepy and laidback, but it seems to wake up at night!

In a year during which everyone seemed to blame the evil hedge funds and fund managers for all the world's ills, my respect for true professionals in our business actually increased. In the early 1990s, a friend of mine who runs money in emerging market debts had advised me to buy some Angolan debt. To simplify things, and since I had no idea about its investment merits, I bought it under his name at 26 cents on the dollar. For the first few years it didn't move; but then suddenly, a few years ago, the government bought its debt back at US$1.56. My friend promptly sent me a cheque for what was due to me. Then, this summer, he had the decency and integrity to advise me that another US$35,000 was due to me and he sent me another cheque. So, although we "money shufflers" don't enjoy a particularly good reputation at present, I would like to say here that the majority of the participants in our industry are very decent, hardworking, capable, and honest people. In the same way that it was wrong of my Shanghainese friend to question the integrity of all Koreans, it would be very wrong to put all the hedge fund and other fund managers in the same basket as dishonest and greedy people and to blame them for the current financial crisis.

But, it was less my intention to write about my fortunate experience in Korea and the good nature of my readers than to explain that, growing from extreme poverty in the 1970s to a high standard of living and a democracy today, South Korea (along with Taiwan, Singapore, and Hong Kong in Asia) is an example of a very successful emerging market economy. And although I had been very positively impressed by the work ethic and independent-mindedness of Koreans in the 1970s (I had also seen them working on construction sites in the Middle East), I could never have imagined how far and how fast South Korea would progress. So, hearing about the great South Korean success story, my readers might be tempted to think that any long-term investment in South Korea would have grown into a considerable fortune. Wrong! In local currency terms, the stock market is at about the same level it was at in 1989, and in US dollar terms it is no higher than it was in 1988 (see Figure 1). I find this remarkable when I reflect on the country's progress over the last 20 years. (Today, Korea has a highly educated population and a superb infrastructure.) Similarly, I was somewhat taken aback when the Japanese stock market recently fell below its 1981 level (see Figure 2). I am fully aware that, since 1990, the Japanese economy has hardly expanded, but when you walk around Tokyo these days there is no doubt that the average Japanese is now far better off than 25 years ago and that the country has built up a formidable infrastructure. In addition, its manufacturing sector is not only innovative and at the forefront of new technologies, but is also highly efficient and is producing top-quality products.

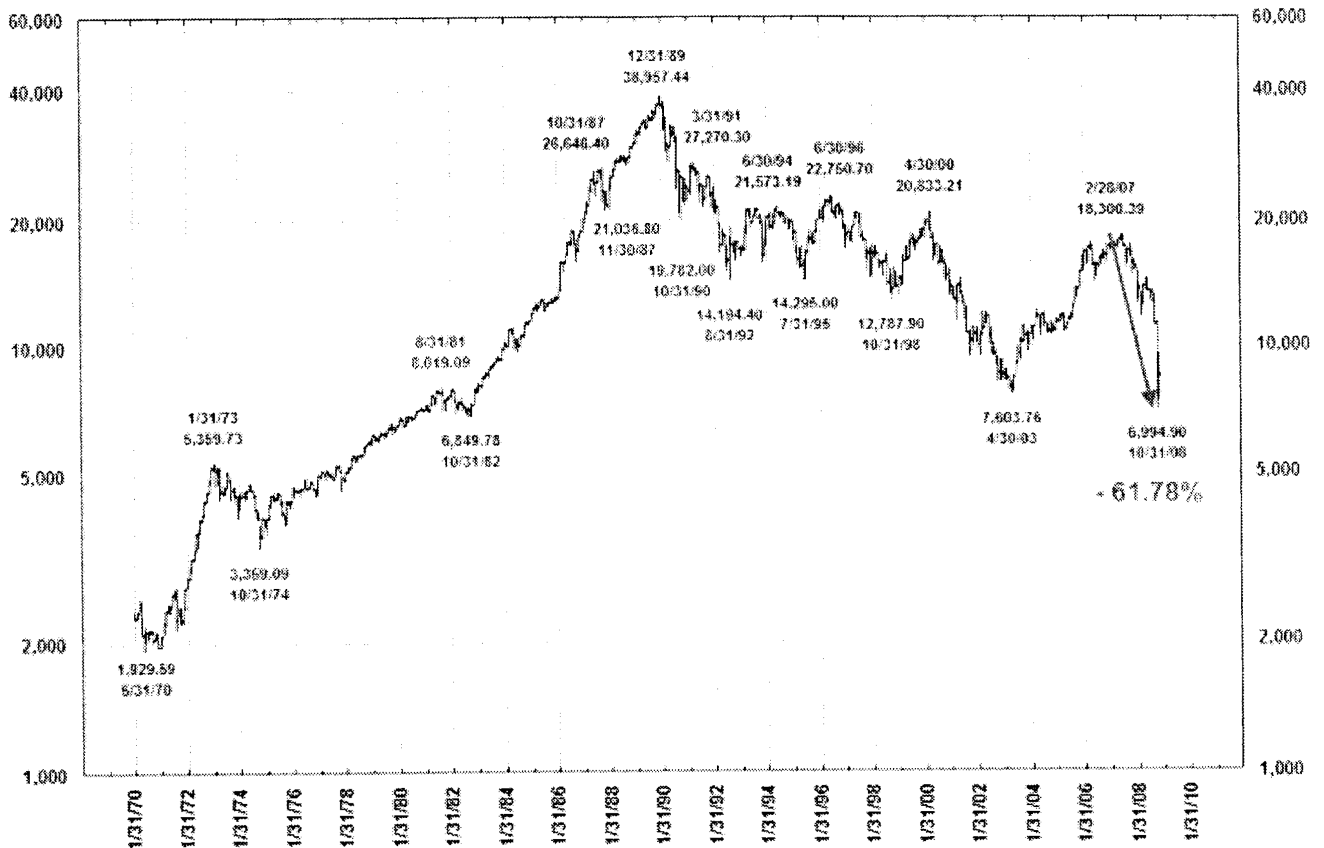
So, I ask myself a number of questions. Are stocks really such a wonderful long-term investment? Why is it that, despite all the economic development that has taken place in Asia over the last 20 years or so, most Asian stock markets have performed so poorly compared to the progress in the region? The Taiwanese stock market has also

Figure 1 **South Korea's KOSPI Index (in USD), 1988–2008**



Source: Bloomberg

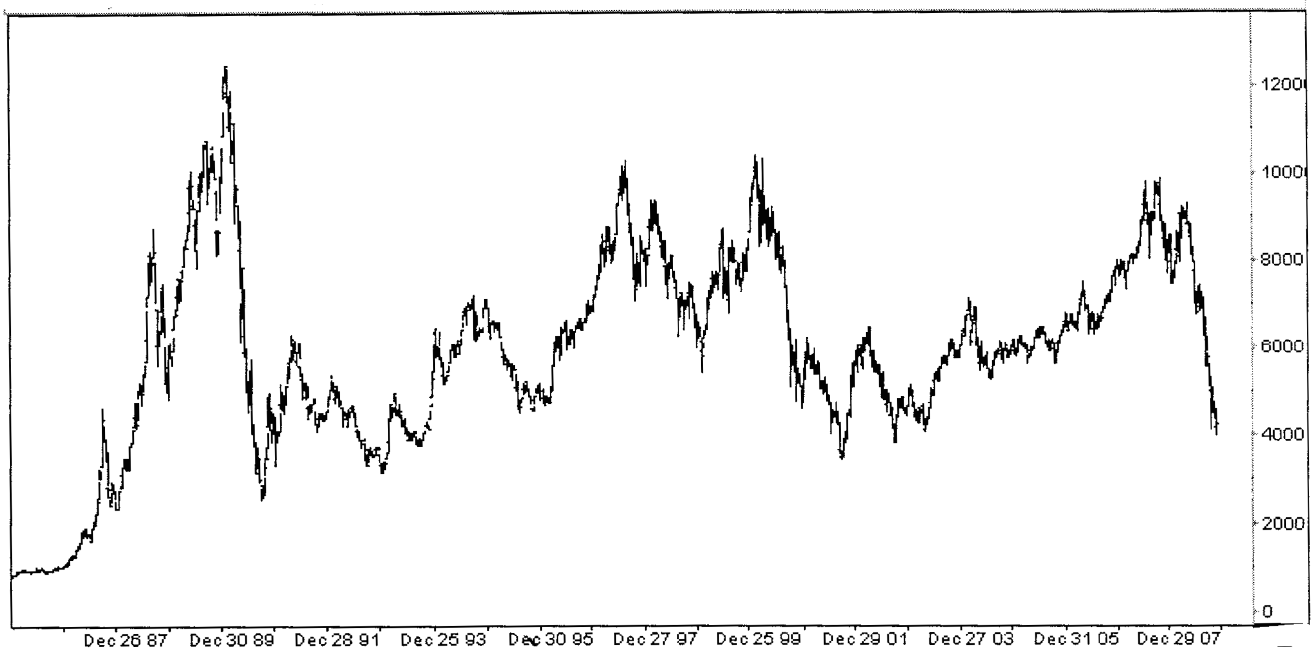
Figure 2 **Nikkei 225 Index, 1970–2008**



Source: Ron Griess, www.thechartstore.com

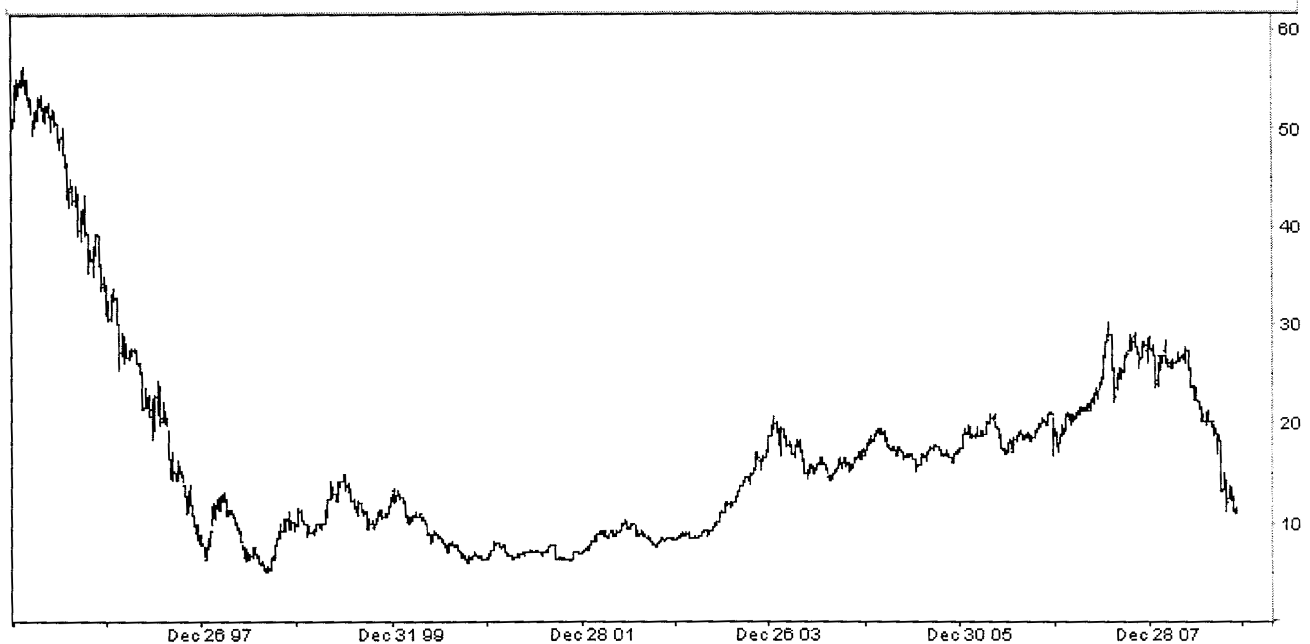
fallen back to its 1987 level (see Figure 3). And following their recent rout, most other Asian markets are far lower than they were in 1997. Is it possible that economic growth has little to do with the performance of equities except possibly over the very, *very* long term? Also, if Asian stock markets could decline to their mid-1980s level, could the US stock market also decline to where it was in the early 1990s? And finally, are the extremely depressed Asian stock markets providing us with a lifetime buying opportunity? After all, whereas Asia is now in recession, the economic conditions are certainly not nearly as bad as they were following the 1997 crisis, whereas stocks are approaching, in many cases, their post-1997 lows (see Figure 4).

Figure 3 **Taiwan TAIEX Index, 1985–2008**



Source: Bloomberg

Figure 4 **Thailand's SET Index, 1995–2008**



Source: Bloomberg

I certainly don't pretend to have all the answers to these questions, since I lean towards the view of the historian Will Durant who opined that "education is a progressive discovery of our own ignorance". However, the quest for answers may provide us with some valuable insights and force us to weigh the pros and cons of the merits of the various investment markets.

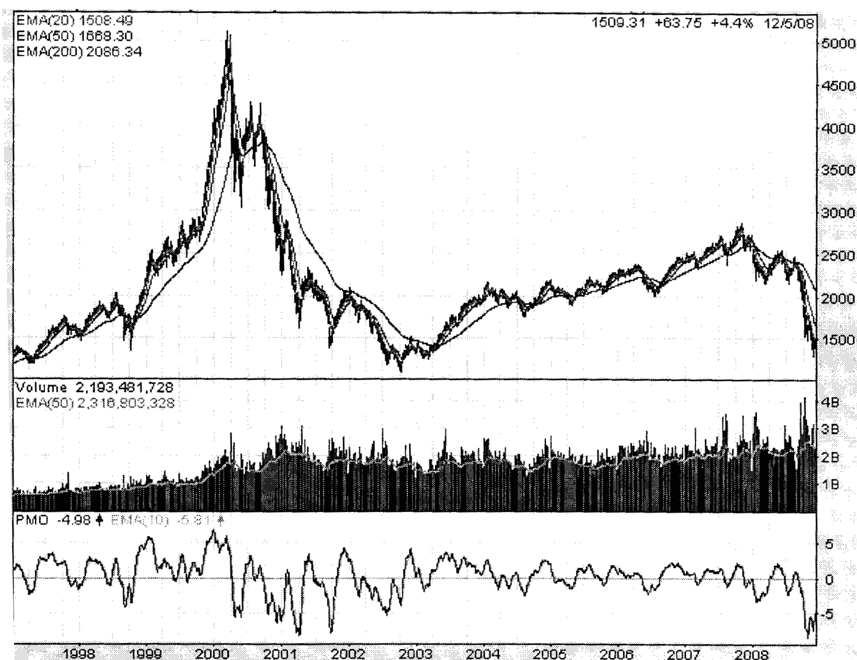
IS THERE A LIFETIME BUYING OPPORTUNITY FOR U.S. EQUITIES?

"There is great disorder under heaven … the situation is excellent," said Mao Zedong, but obviously the situation wasn't excellent for the Nationalists who were overthrown by the Communists. I am mentioning this because there is a widespread consensus that when blood flows in the streets, a buying opportunity automatically arises. In fact, when the Communists took over Shanghai in 1949 the stock market's first reaction was to rally, because it was argued that China had gone through many revolutions and that with the civil war out of the way the economy and the business environment would improve. However, within a few years China's capitalists were expropriated and were fortunate to get away alive. Now, I am in no way suggesting that shareholders and other asset proprietors around the world will be expropriated, but I just wanted to point out that even if shares are down 50% from their highs it doesn't necessarily make them inexpensive and attractive for investors. For now, I am not saying that equities are not attractive, but not for the reason that they are down by 50% from their highs a year ago. Equities could be attractive for other reasons, which we shall need to analyse. The Japanese stock market wasn't attractive after it had declined by 50% from its 1989 peak and traded between October 1990 and 2000 in a range of approximately 14,000 to 22,000 for ten years (see Figure 2). Equally, the Nasdaq wasn't attractive after it had declined by 50% from its 2000 high at 5,132, since it is now selling at around 1,550 (see Figure 5). This trivial observation also applies to other asset markets. Sugar touched 70 cents per pound in 1973, and silver soared to US$50 per ounce in 1980. At half their prices, these commodities were still totally unattractive. (Sugar sells now for 11 cents per pound and silver for US$10 per ounce.)

So, the fact that a market sells off by 50% should seriously concern investors that some important fundamental conditions have changed for a long time to come, rather than make them confident that, due to the "depressed" asset prices, future returns will be high (a strong rebound aside). I have seen far more assets which, having declined from their highs by 50%, have proceeded to decline by at least another 50%, than assets that immediately resumed their up-trends. "All wrong," some market observers will say. They will point to gold, which between December 1974 and August 1976 fell from US$195 an ounce to US$103, before surging another eight-fold to its 1980 high. They will also point to the US stock market low in 1974 from which a very strong rebound followed, and to 1987, when after a 40% decline from peak to trough the stock market resumed its up-trend. (Taiwan dropped 50% and then went up another four-fold.)

This is all correct! In particular, the 1973/74 bear market and the subsequent rebound in 1975 does have at least some similarities with the present situation. The Dow Jones had peaked out at 1,067 in January 1973. It subsequently fell and bottomed out at 570 in December 1974 (see Figure 6). But, by July 1975 the Dow had rebounded to 888 and even reached 1,018 in March 1976. In late 1974 the economy looked horrible and contracted in the first quarter of 1975 at an annual rate of 7%, yet the market rebounded from December 1974 onward. (As an aside, the largest stock market capitalisation companies in the US were then: IBM, AT&T, Exxon, Eastman Kodak, General Motors, and Sears.) Also, in real terms the stock market had reached a peak in 1966 and had at its 1974 low (eight years later) declined by 65% from its peak (see Figure 7). Similarly, the stock market peaked out in real terms in 2000 and has now declined in real terms by 50% (eight years later). I

Figure 5 **Nasdaq Composite ($COMPQ), 1998–2008**



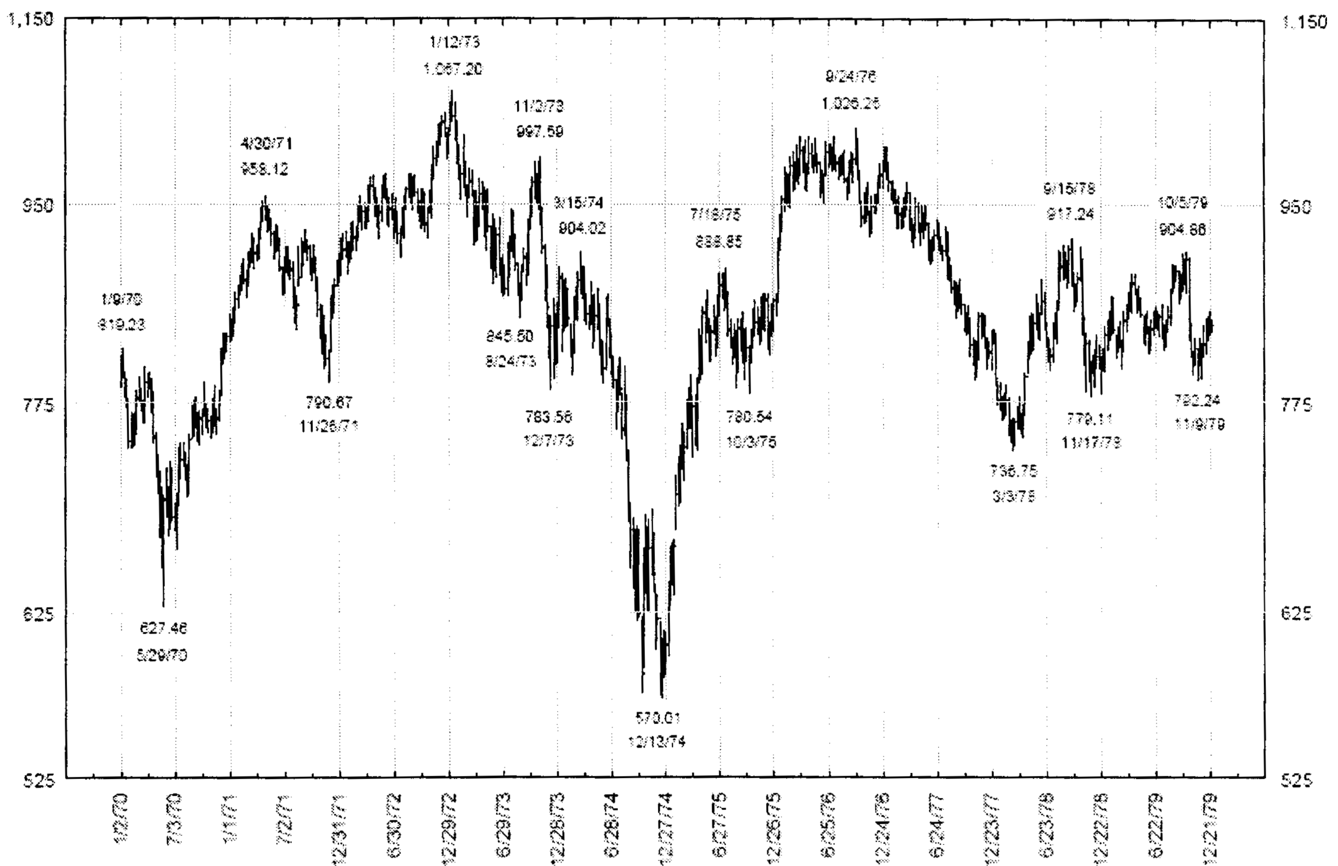
Source: www.decisionpoint.com

therefore have sympathy for the argument that, given the similar economic conditions at the end of 1974 and at present and the "depressed" level of equities in both instances, a powerful rebound could unfold despite further erosion in the economy in early 2009. However, we should also consider some differences between the 1974 and current stock market lows. The first, and most obvious, difference is that in 1974 equities were incredibly depressed in real terms. Disregarding dividends, the S&P 500 was, when adjusted for inflation, lower in 1974 than it had been in 1906. Currently, while down by 50% from its 2000 peak the S&P 500 is still, inflation-adjusted, at its highest level in the history of the US stock market with the exception of the 1995–2007 period. (The prior inflation-adjusted peak had been in 1966 — see Figure 7.) Also, at its 1974 stock market low the Dow Jones had a dividend yield of more than 6%, it was selling at a significant discount to book value, and the entire stock market capitalisation was just 31% of GDP (currently still close to 100%). In addition, profit margins were at a historical low (see Figure 8). By all these measures, the stock market is currently far less depressed than it was in 1974. Ron Griess (www.thechartstore.com) put a figure together which shows the S&P 500 compared to the Implied Valuation based on the Graham and Dodd Valuation Model (see Figure 9). As can be seen, the stock market was extremely depressed based on this valuation model in 1974 and in 1979, but is at present still in overvalued territory. Lastly, and I think this is an important difference between the 1974 low and the present one, in 1974 debt to GDP was only 120%, the saving rate was still 12%, and derivatives hardly existed. In other words, the system was far less leveraged than it is today.

There is another angle to consider. Whereas the stock market made a major low in 1974 in nominal terms, inflation-adjusted — following a brief but powerful rebound into the spring of 1976, it continued to decline until 1982 (see Figure 7). At the same time, the US dollar lost another 40% against the German Mark between 1974 and 1980.

I can see many similarities between the 1974 low and the present conditions. I also believe that the stock market is even more oversold now than it was in 1974. So, whereas the 1973/74 bear market lasted almost two years, the current rout occurred within one year. However, as we have just seen, I can make a strong case that stocks are far less depressed at present than in 1974 and that the economy may be in for a far lengthier period of discomfort than in 1974/75. After all, the 1974/75 recession was brought about by rising interest rates, the oil shock,

Figure 6 **Dow Jones Industrial Average (weekly), 1970–1979**



Source: Ron Griess, www.thechartstore.com

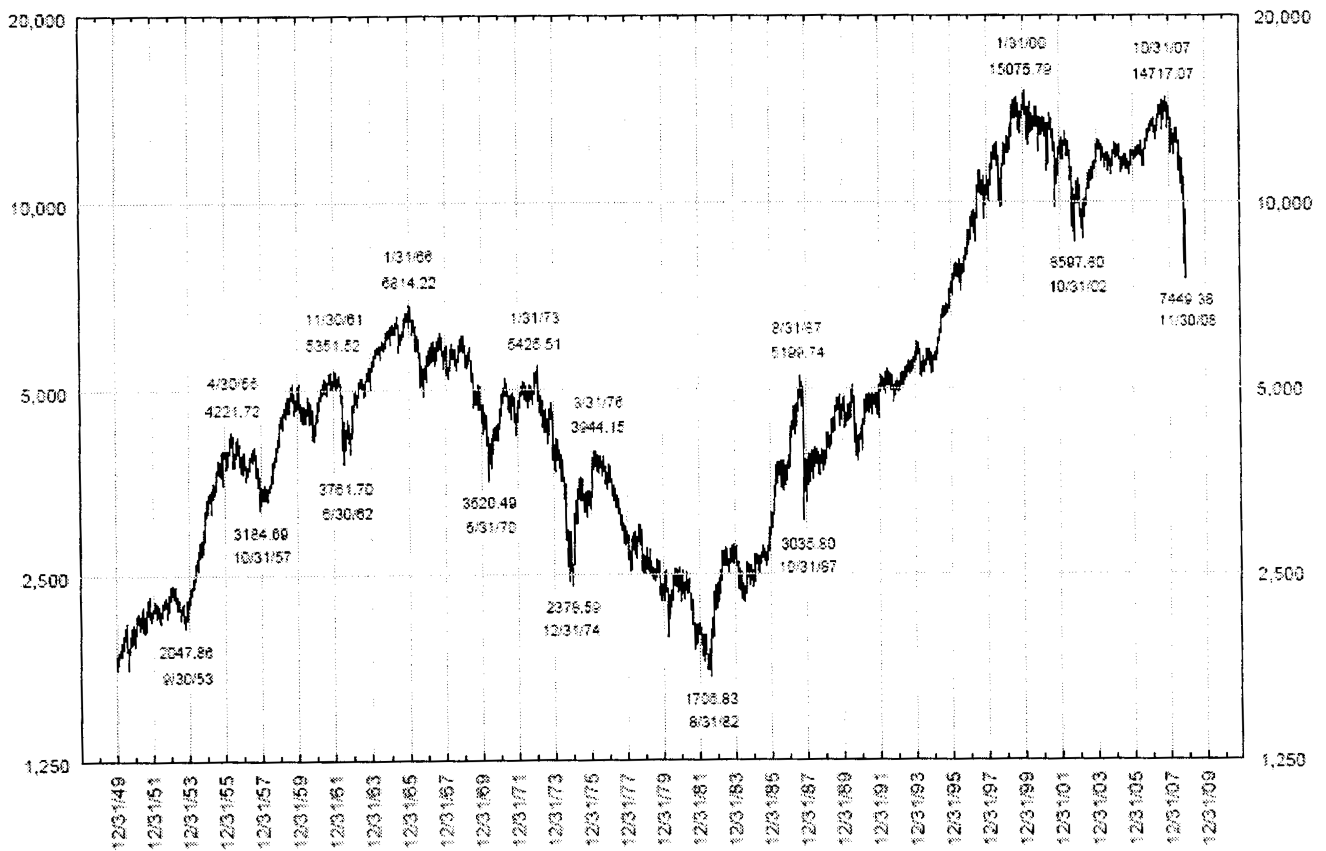


Figure 7 **Dow Jones Industrial Average (monthly – adjusted for inflation by the CPI – all items), 1949–2008**

Source: Ron Griess, www.thechartstore.com

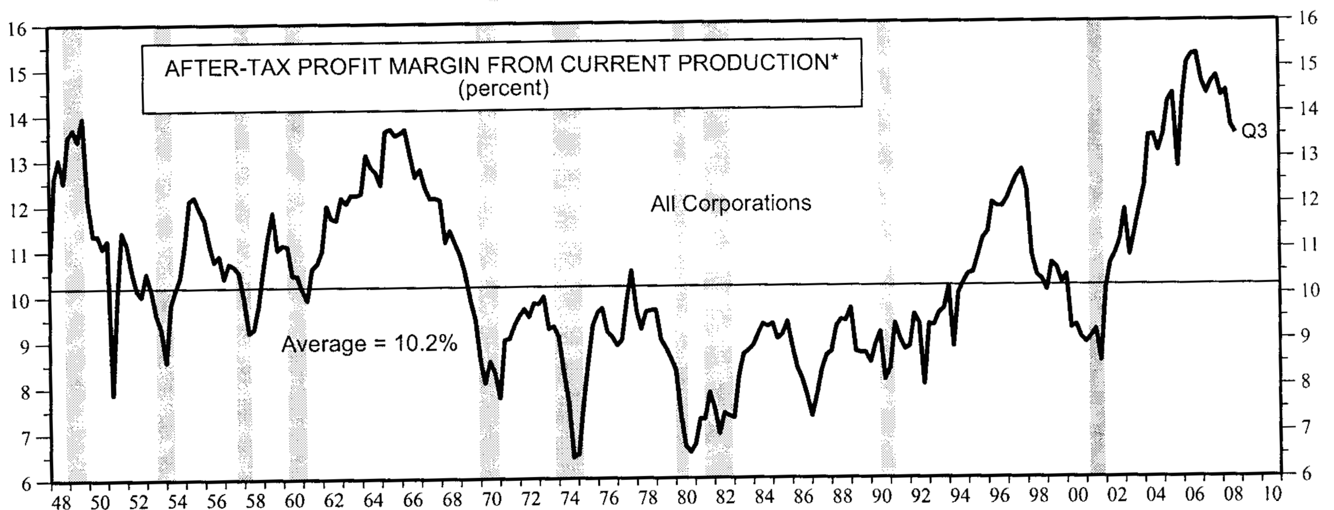
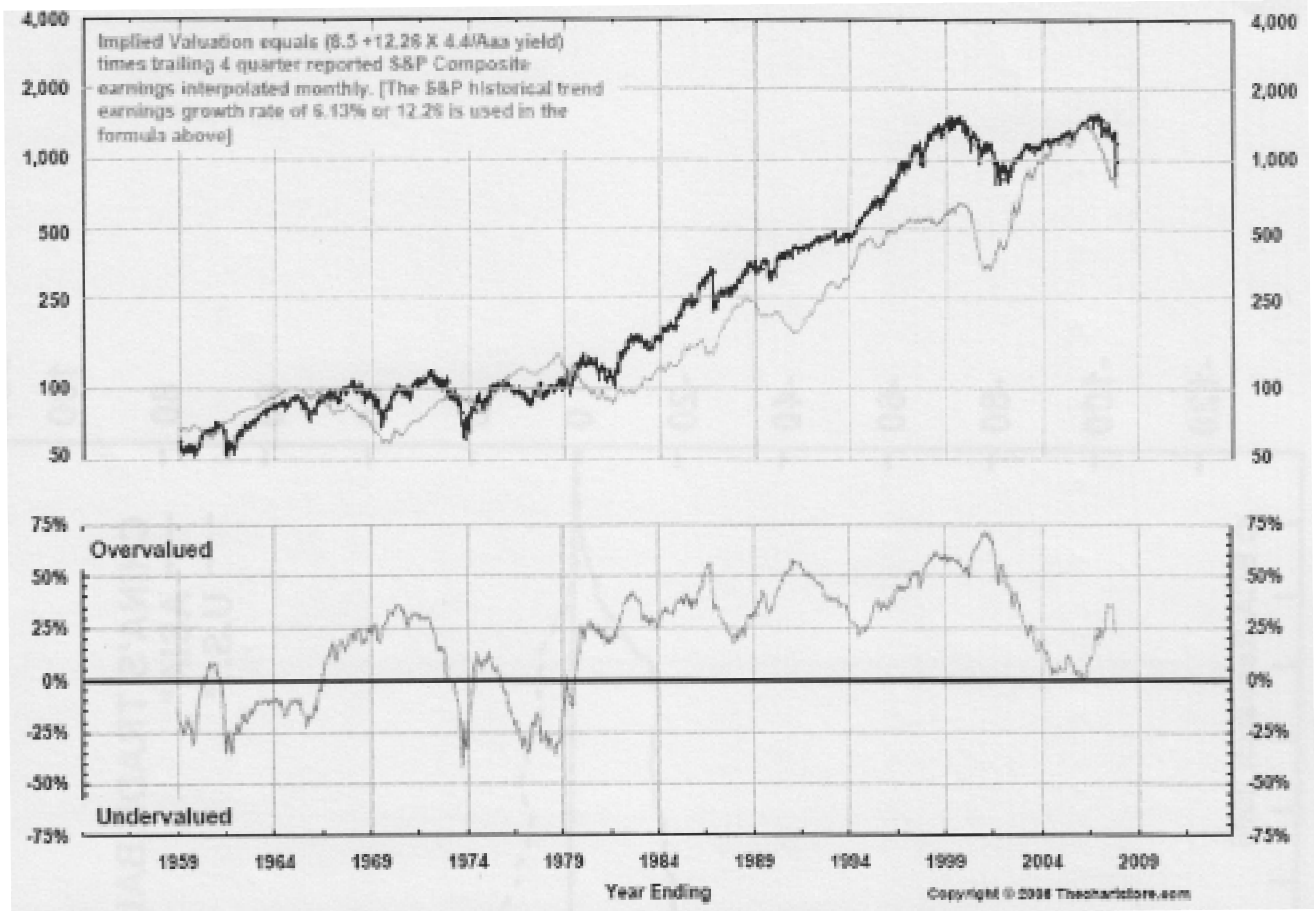


Figure 8 **After-tax Profit Margin from Current Production (%), 1948–2008**

Source: Ed Yardeni, www.yardeni.com

Figure 9 **S&P Composite and Implied Valuation based on Graham and Dodd Valuation Model (monthly), 1959–2008**



Source: Ron Griess, www.thechartstore.com

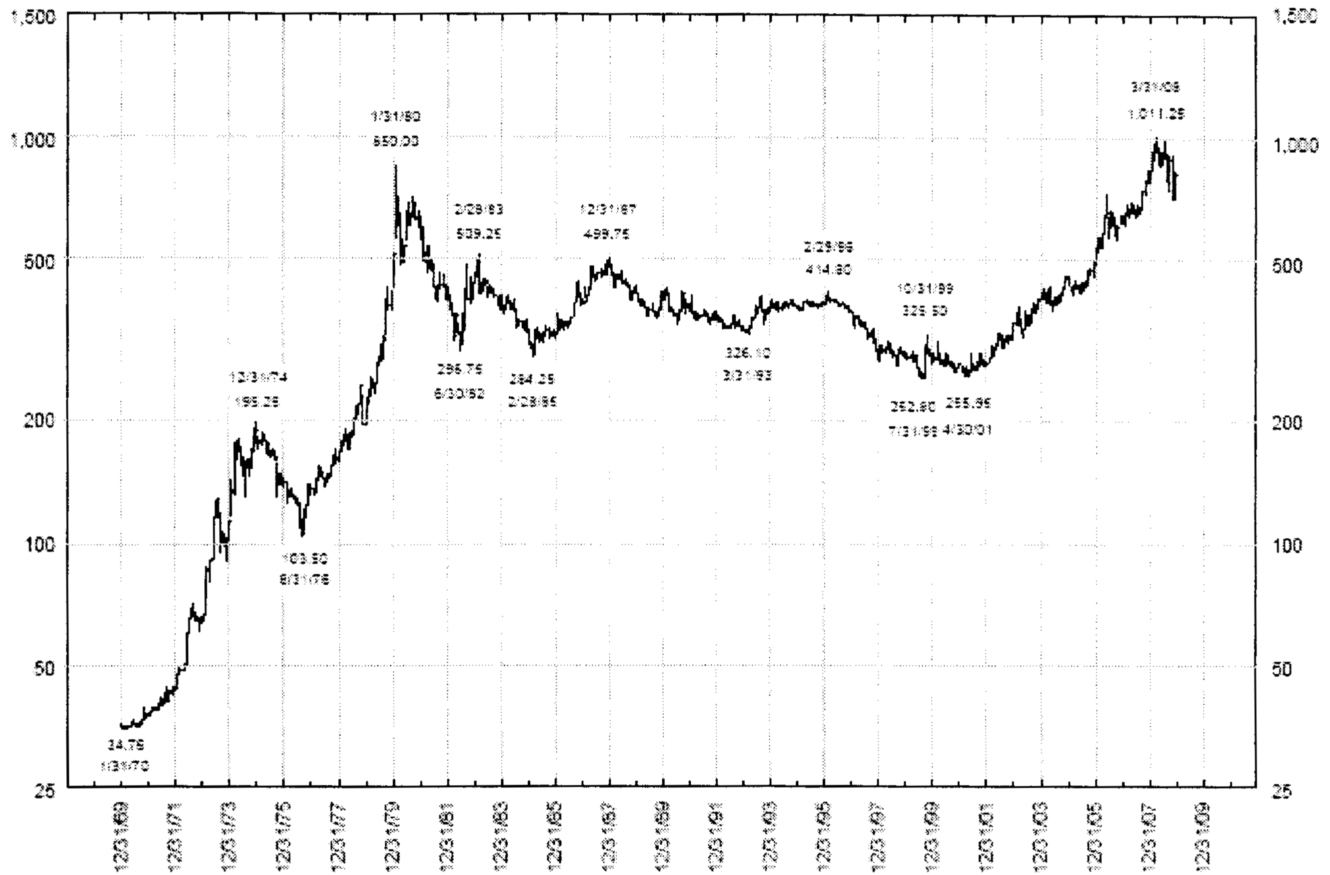
and a large inventory liquidation, whereas the current downturn is a consequence of excessive debt in the system brought about by artificially low interest rates (read "Fed policies"). In addition, the still high level of US equities in inflation-adjusted terms does concern me, which brings me to another thought.

If someone really felt that the similarities between the 1974 low and current market conditions are overwhelming, he should consider purchasing gold and oil rather than US equities (and also shorting bonds). As I have explained above, gold corrected between the end of 1974 and the summer of 1976 by 40%, while the stock market surged. But from its August 1976 low, the gold price then increased eight-fold (see Figure 10). At the same time, because oil prices rose between 1974 and 1980 from US$12 per barrel to US$39, energy and energy-related shares (including engineering companies) were until the end of 1980 the best-performing stocks. (The rest of the market hardly moved.)

Therefore, my thinking is that if we are really in an environment such as we were in at the 1974 lows (and I have serious reservations about this assumption), then we should expect some further weakness in gold prices when equities rebound. Such weakness would then provide an excellent buying opportunity. However, keep in mind that even if you bought gold at its 1974 high at US$196 per ounce, by 1980 you would still have quadrupled your money, which was far better than the return the stock market provided (see Figure 6 and also Figure 10). So, even if you endorse the view that we are in a similar situation as in 1974, I would be reluctant to stay out of the gold market entirely in the hope of buying it at lower prices. Another reason why gold may not sell off as much as it did between 1974 and 1976 is that governments' interventions with monetary and fiscal measures around the world are unprecedented. And whereas I have serious doubts that these interventions will improve the economic conditions (I believe they are likely to make them worse), they could temporarily lift asset prices and lead at the same time to a further erosion of confidence in paper money.

I have tried to show above that the US stock market is nowhere near as depressed as it was in 1974, and that the entire financial system is also far more unstable (due to the leverage) today than it was then. At the same time, I accept the view that the stock market is currently

Figure 10 **Gold in US Dollars, 1969–2008**



Source: Ron Griess, www.thechartstore.com

extremely oversold — in fact, by some measures even more oversold than it was in 1987 (see Figure 7). However, we also need to be careful when comparing current conditions with 1987. The equities bull market that began in 1982 started from an extremely low valuation and after a 16-year bear market in inflation-adjusted terms (see Figure 7). Also, in 1982 the Dow Jones was no higher than it had been in 1964 — 18 years earlier. Currently, the US stock market is at about the same level as in 1998 (ten years earlier), and in real terms the bear market lasted just eight years (see Figure 7). Therefore, in 1987 the bull market was only five years old and had originated from a base-building period in nominal terms of 18 years and from a vicious bear market in real terms that had lasted 16 years. In other words, compared to the previous bear market in real terms and the lengthy sideward move in nominal terms the bull market in 1987 was still relatively "young". (In inflation-adjusted terms, we were still below the 1966 high.) This is quite different today. Before the market's decline, which began in October 2007, the US stock market had been in a bull market in both nominal and real terms, which had lasted 18 years if we take year 2000 as the peak. If we measure the bull market in nominal terms, it had lasted 25 years (1982–2007). In addition, I should like to point out that it would be acceptable also to take 2007 as the peak in inflation-adjusted terms because the market had almost fully recovered following the bear market between 2000 and 2002 (see Figure 7). So, from this perspective, the bear market in real terms would be just a little over one year old.

This may all sound very complicated, but I pay a lot of attention to "time" in the analysis of economic and asset price cycles. If an up-cycle was brief, the down-cycle is also likely to be brief. If the up-cycle lasted a very long time and was accompanied by huge excesses, the downturn from the peak of such a cycle is also likely to be lengthy — as was the case for gold after 1980, and for the Nikkei and the Japanese economy post-1990 (see Figure 2). Similarly, if a down-cycle lasted a long time (20–30 years), the up-cycle is also likely to last for an extended period of time. This leads me to another observation concerning pundits who compare the present to 1987. As we have just seen, when the stock market crash occurred in 1987 the bull market was just five years old. The equities bull market that preceded the current bear market,

which began in late 2007, lasted, depending on one's perspective, between 18 and 25 years (see above). **But there is one asset class — commodities — that is in a similar position to equities in 1987**. Let me explain. In 1987, prior to their bear market, equities had become extremely overbought. The same can be said of commodities in July 2008 (see Figure 11). The 1982–87 bull market in equities followed a 16-year bear market in inflation-adjusted terms. The 2001–08 bull market in commodities followed a 26-year bear market in inflation-adjusted terms (see Figure 12). Lastly, if we are already talking about over-sold markets, commodities, which in many cases have declined by more than 70% from their July 2008 highs (crude oil is down 71%), would seem to be far more over-sold than US equities (see Figure 11). **Therefore, based on my time/cycle analysis above, commodities and commodity-related shares would also seem to be in a far more favourable position to resume their up-trend than broad US equity indices, which (a sharp rebound aside) are unlikely to enter a sustained longer-term bull market.**

WHAT ABOUT LIFETIME BUYING OPPORTUNITIES IN EMERGING MARKETS?

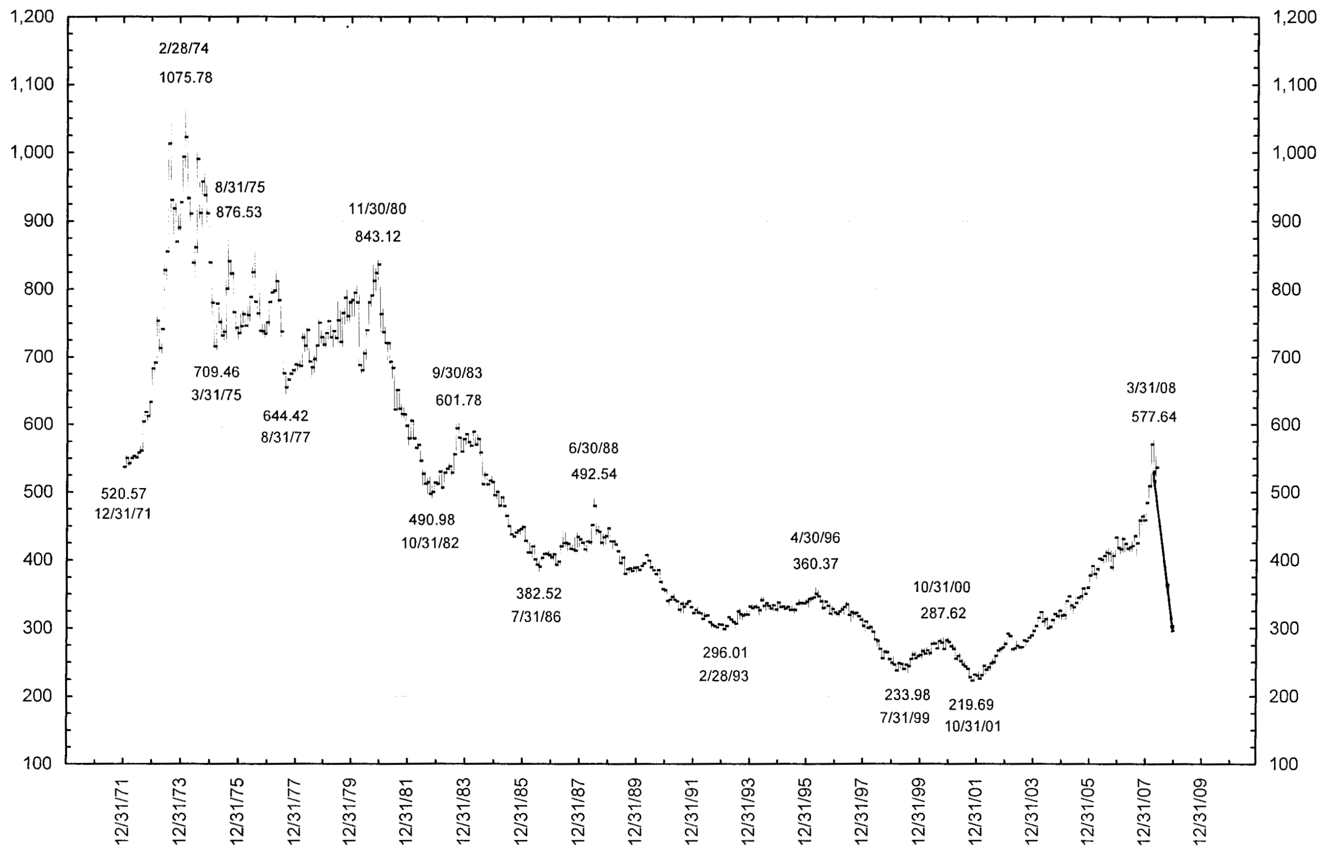
In my introduction I wrote about South Korea and Japan, and the dismal performance of their stock markets since the late 1980s (see Figures 1 and 2). One point which I didn't mention, however, is that following the purchase of my Korean and Taiwanese shares in the late 1970s I had to wait six years to make any money as these stock markets moved sideward between the late 1970s and 1985. There was a brief stock market spike in 1979/80, but the 1981/82 recession knocked stock prices down again. A four-year base-building period then followed before these markets took off (see introduction). However, during this period of sideward movement I got paid for waiting, because at the time the dividend yield on Korean shares was in excess of 7%.

Recently, much noise has been made among the investment community about the dividend yield on the S&P 500 exceeding the ten-year Treasury bond yield for the first time since 1958. This event was widely interpreted as a sign of how inexpensive US equities were. What wasn't mentioned was that, throughout the 19th century, stock dividend yields exceeded bond yields, and even in the 20th century (until 1958) dividend yields always exceeded Treasury bond yields with the exception of in 1929. Also not mentioned was that whereas dividend yields in the US now just marginally exceed the yield on ten-year Treasury bonds, the stock/bond yield spread is far wider in most Asian stock markets. In a research report in which Albert Edwards, strategist at Société Générale (albert.edwards@sgcib.com) writes about how the equity/bond relationship would change in a world of low inflation, and how in an "Ice Age" the de-rating of equities is now "in full throttle", he points out that in Japan the dividend yield of equities is now twice the ten-year bond yield (see Figure 13). Along the same lines, our friend Chris Wood, the eminent CLSA strategist (christopher.wood@clsa.com), points out that based on stocks under CLSA's coverage, stock markets in Hong Kong, Malaysia, Singapore,

Figure 11 **CRB Index, 1999–2008**

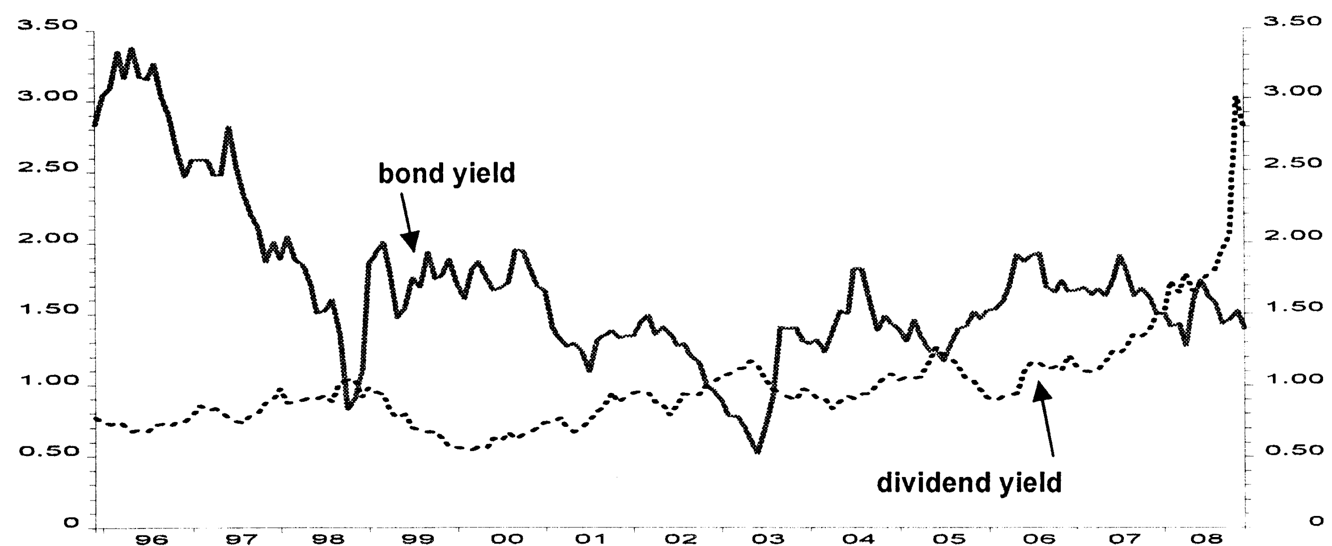
Source: Bloomberg

Figure 12 **Reuters/CRB Continuous Futures Index (adjusted for inflation by the CPI – all items), 1971–2008**



Source: Ron Griess, www.thechartstore.com

Figure 13 **Japan: Bond Yield and Dividend Yield, 1996–2008**

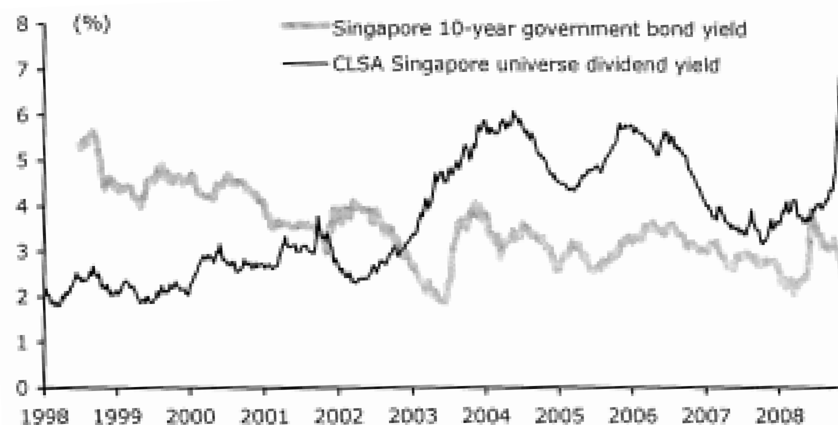


Source: Albert Edwards, Société Générale

Taiwan, and Thailand now yield 6.7%, 6%, 6.5%, 7.8%, and 7.5%, respectively, while the local ten-year government bond yields in these countries are 1.6%, 3.7%, 2.3%, 1.7%, and 3.8%, respectively (see Figures 14 and 15). In other words, in Hong Kong, Singapore, and Taiwan, stock dividends exceed bond yields by at least three times! It's noteworthy that in Singapore and Taiwan the stock market yield began to exceed the bond yield as early as 2003, but that despite this condition these stock markets have also been hit very hard in the last 12 months. I have been fascinated by the stock/bond yield since I started working for White Weld in the 1970s, because it was always my view that when stocks have a significantly higher dividend yield than bonds (as in the 1940s in the US), growth expectations are extremely low; whereas when equities' dividend yields are far below bond yields, growth expectations are very high. There can be exceptions to this general rule: between 1929 and 1932, stocks collapsed and dividend yields soared because the market rightly perceived that dividends would be cut (see Figure 16, courtesy of the great Peter L. Bernstein who wrote an excellent report on the subject which he has generously offered to share with interested parties (contact him at www.peterlbernsteininc.com, fax: 1-212-421-8537). As an aside: I am frequently asked by my readers how they can learn more about economics and investments. I think there are few more educational reports around — it's not always an easy read — than Peter Bernstein's *Economics and Portfolio Strategy*. Peter is the author of several outstanding books and numerous academic papers and a man of great personal and professional integrity who still finds time to write me personal letters on fine paper (not e-mails). This I like! So, if you can have him as a "teacher" and "mentor", such as I was fortunate to have him, you will benefit enormously.

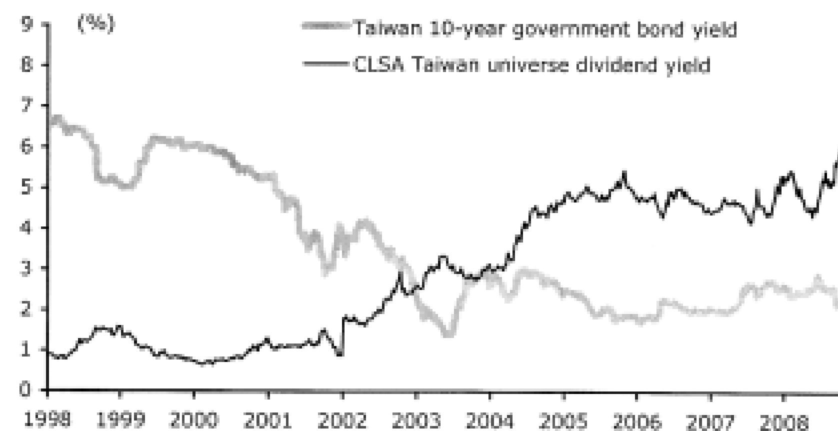
Back to the stock/bond yield spread! As just mentioned, when stocks yield far more than bonds,

Figure 14 **CLSA Singapore Universe Dividend Yield and Ten-year Government Bond Yield, 1998–2008**



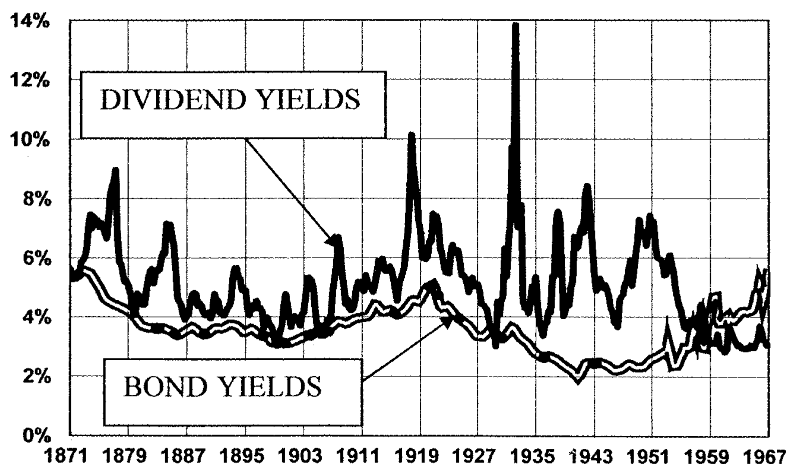
Source: Chris Wood, CLSA

Figure 15 **CLSA Taiwan Universe Dividend Yield and Ten-year Government Bond Yield, 1998–2008**



Source: Chris Wood, CLSA

Figure 16 **Dividend Yields versus Bond Yields, 1871–1967**



Source: Peter L. Bernstein, www.peterlbernstein.com

either expectations about dividend cuts are very high or growth expectations are very low, as was the case in the 1940s and early 1950s (see Figure 16). Therefore, the current high stock/bond yield differential in Asian markets may suggest some dividend cuts (see Figures 14 and 15). And indeed, I would expect, in a worst-case scenario, dividends to be cut by at least 50%. But even if such cuts were happening, equities would still yield more than bonds. My view is therefore that compared to holding cash and bonds, equities provide me with a sufficient cash flow to wait for the next bull market whenever it may come. (My guess is not very soon.)

Now, if I combine the high dividend yield on Asian equities compared to the local bond yields and the fact that most Asian markets are close to their early or late 1980s level, I feel reasonably comfortable purchasing some high-quality Asian equities. But let me explain the context in which I am buying these.

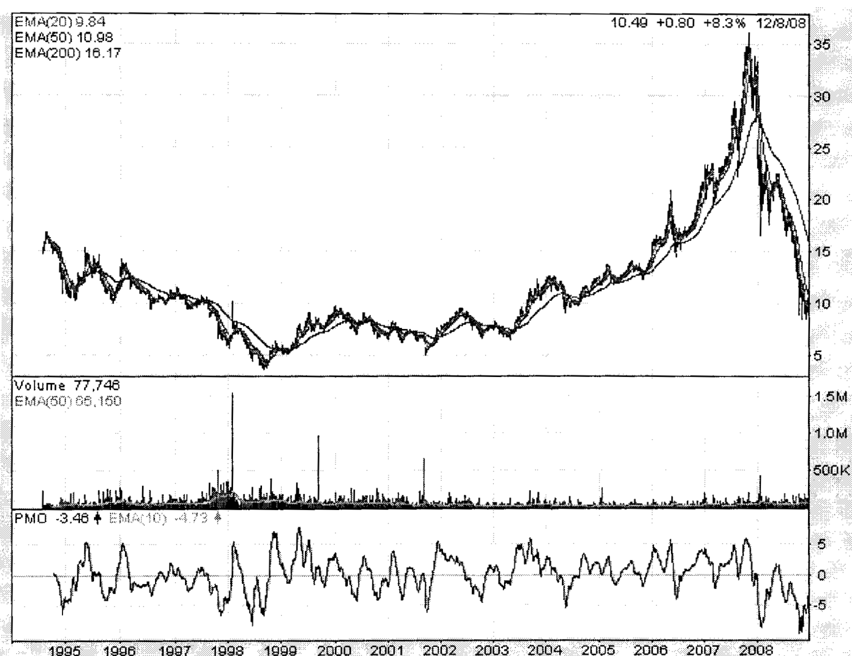
Economic conditions around the world are horrible and will get far worse in 2009 despite all the fiscal and monetary measures that are now being implemented in order to "save" the system. In fact, I believe that in the US the stimulus package and the various bailouts engineered by the Fed and the Treasury will make matters far worse than if the free markets had been left alone to make the necessary adjustments. Look at Japan post-1990! How many bailout packages and stimulus packages have been implemented since then? And how have the economy and the stock market performed? Figure 2 will give you the answer. The cause of the current economic slump isn't the financial crisis and free markets that failed, but ill-conceived government policies, which handed out privileges to special interest groups such as Fannie Mae, Freddie Mac, and the financial establishment — in particular, Wall Street. The economic slump was also caused by the Fed's intervention in the market for interest rate pricing — especially after 2001 when the Fed fund rate was cut from 6-1/2% to 1%.

Another cause of the slump was the bailout of LTCM, which encouraged financial institutions to increase their leverage. In a free market, LTCM would have failed and the surviving market participants would have been much more prudent in taking large debts on their balance sheets. Therefore, it isn't free markets and the capitalistic system that have failed; rather, governments and government agencies that have intervened in the free markets should bear the responsibility for the current economic contraction of which the financial crisis is just a symptom. Now, I understand that financial institutions applaud the bailout packages, the monetary interventions, and the Obama stimulus package. After all, they don't have an insignificant self-interest in replenishing the half-empty bucket of assets around the world in order to get their management and performance fees increasing again. But it should be clearly understood that the root of the problem is excessive debt in the system and that, so far, all the bailout and fiscal measures haven't addressed this problem. In fact, I believe that the governments' and their agencies' fiscal and monetary interventions will worsen rather than improve the outcome as debts are simply shifted from the private sector to governments. A price (higher taxes, higher inflation, defaults, etc.) will have to be paid sooner or later.

It is utter nonsense to believe that governments know how to run an economy better than free markets, and that interventions can solve problems. Interventions may solve some problems temporarily, but they create far greater problems down the road. But if any reader of this letter sincerely believes in governments' interventions, they should pray for a total nationalisation of their economies and let people like Ben Bernanke and Hank Paulson run the business. Good luck! Personally, I agree in this context with Will Durant (quoted previously) who wrote that "one of the lessons of history is that nothing is often a good thing to do and always a clever thing to say".

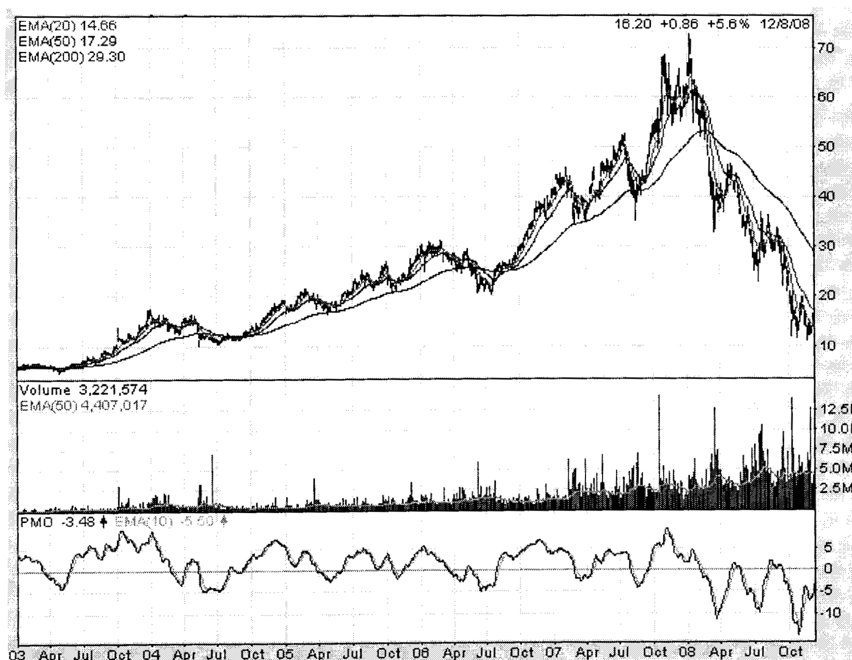
Above, I mentioned that economic conditions today are horrible. However, since it is the beginning of a new year I don't wish to further depress my readers and so I shall refrain from publishing statistics that point to the ongoing economic catastrophe around the world. (I have done this sufficiently over the last 12 months.) The good news today is that whereas 15 months ago the mood was exuberant (reflected in the stock markets' new all-time high towards the end of 2007), the mood today is one of despair. Even the media, which a year ago dismissed the sub-prime crisis as an isolated event, is now universally negative. In Asia, investment banks, private banks, and investment funds are closing their offices or meaningfully reducing their staff. This is excellent news for the economy, because it will make housing and living expenses more affordable for people who actually make a **positive** and **productive** contribution to society and to the economy. By eliminating competition, the surviving firms will also regain their pricing and earnings power, which is the way a free market should work. Capitalism isn't about the survival of the weakest (Detroit), but of the fittest, as painful as this may be at times. Aside from closures of financial sector companies in Asia, foreigners have been heavy net sellers of equities in the second half of 2008. What really concerned me about emerging market equities in the summer of 2007 is that when visiting with family offices in the US everyone was telling me that they had approximately 50% of their money in foreign equities, with a large overweight in emerging markets. BRIC investing was then the favourite buzzword, along with the US dollar weakness and decoupling of emerging economies theme. But now that many foreigners have learned the painful lesson about lack of liquidity in emerging markets and financial connectivity, they have sold down their holdings at any price. In the final months of 2008, "get me out" was the order of the day as hedge funds and other financial

Figure 17 **Asia-Pacific Fund, Inc. (APB), 1995–2008**



Source: www.decisionpoint.com

Figure 18 **ICICI Bank Ltd (IBN), India, 2003–2008**



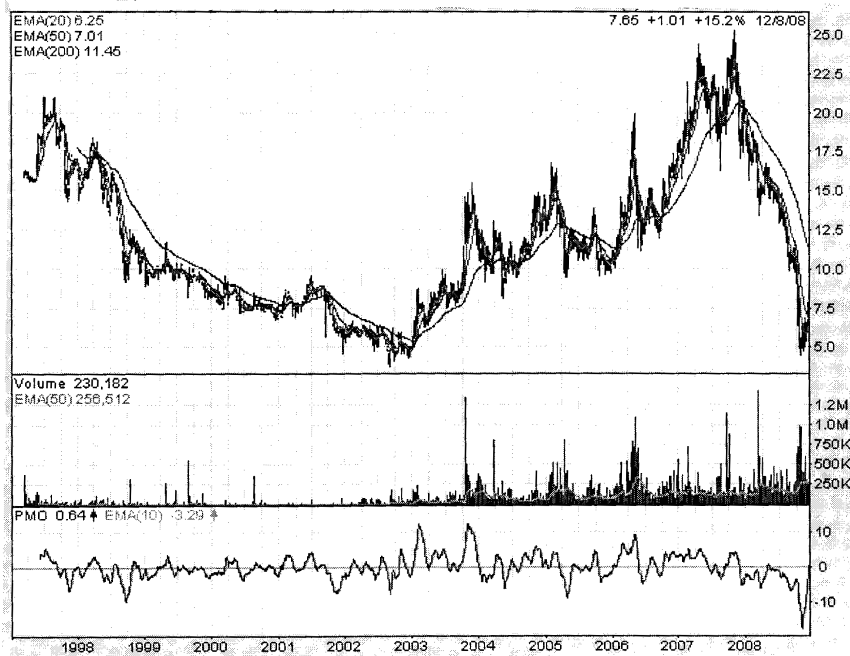
Source: www.decisionpoint.com

institutions rushed to deleverage their exposures and build up their liquidity. It would seem to me, therefore, that the bulk of the selling is already behind us and that, due to lack of liquidity, emerging stock markets could rebound sharply in the next few months. This isn't to say that the recent lows won't be tested again in 2009, but that a rebound is now the path of least resistance (see Figure 17). Usually, following a stock market rout such as we have just experienced in 2008, a lengthy base-building period occurs during which confidence gradually returns is the likely outcome. This occurred following the Asian and other crises in the past, but the point is that investors with no exposure to Asia and other emerging economies should consider the accumulation of some quality equities in emerging economies around the world even if it is only for a three-month trade (see also Figures 18, 19 and 20).

In the past, I have written positively about Singapore REITs. Initially, they appreciated moderately but over the last six months they have imploded by more than 50%. (I also had to eat some humble pie in 2008.) Currently, based on past earnings, they provide extremely high dividend yields (see Table 1 on page 16). I have no doubt that most of these REITs will cut their dividends by at least 50% in 2009 (possibly even by 70%), but even if they do so these real estate investment trusts will provide far higher dividend yields than Singapore government bonds. Moreover, the market has probably already largely discounted such dividend cuts. My current favourites are Ascendas REIT (AREIT SP), Ascott REIT (ART SP), First REIT (FIRT SP), and Suntec REIT (SUN SP).

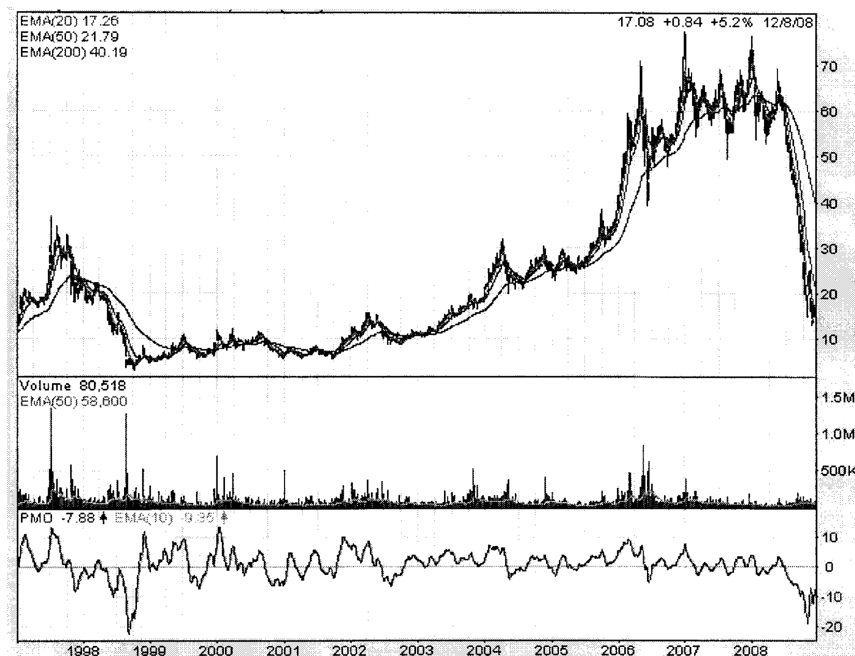
I have mentioned Singapore REITs for two reasons. Compared to cash or government bonds' returns, even under a scenario of a 70% dividend cut they would seem to be relatively attractive. Certainly, the Singapore dollar is a far sounder currency than the US dollar. Furthermore, in the last few years sentiment has repeatedly changed between an inflationary and deflationary scenario. Recently, as evidenced by the higher dividend yield on equities compared to bond yields, the consensus has shifted once again to a highly deflationary scenario (see also Figures 13, 14, 15 and 16). At present, we are clearly in an asset deflationary environment; therefore, a whiff of deflation in consumer prices in 2009 is quite possible. Perhaps we shall have even

Figure 19 **Cresud (CRESY), 1998–2008**



Source: www.decisionpoint.com

Figure 20 **Templeton Russia Fund, Inc. (TRF), 1998–2008**



Source: www.decisionpoint.com

more deflation in 2010, but we should not forget that the worse the economy becomes the more money Mr. Bernanke will print, and that the budget deficits will grow larger and larger the longer the economy slump lasts. At some point, these loose fiscal and monetary policies will yield substantially higher inflation rates. Therefore, taking a five- to ten-year view, I doubt that US Treasury bonds will provide a satisfactory return.

CONCLUSIONS

I am far from certain that US equities, which have declined by about 50% from their highs, are such a bargain. Valuations are far from where they were at major market lows such as in 1932, 1974, and 1982. Moreover, economic conditions may turn out to be far worse than in previous recessions, including the Great Depression at the beginning of the 1930s. Everybody seems to think that, thanks to the government's monetary and fiscal interventions, this recession will come nowhere near the 1930s' slump. However, I think it might be far worse — *and precisely because of the interventions*. I am also concerned about politics in the US. "Change" was the buzzword of the Obama campaign. Likely, it will be "change for the worse" (admittedly hard to imagine following the Bush administration). One need look no further than to the people Mr. Obama has appointed to his cabinet. (Michael Steinhardt refers to the new president as a blank slate and opines that "we have a new president who I find to be an absolute tabula rasa in terms of his knowledge of anything", and advises: "Pay attention to what Obama says and you will find he hardly ever says anything of consequence.") The latest scandal involving Illinois governor Rod Blagojevich, while not necessarily representative of all US politicians, is nevertheless hard to swallow! He was the fourth of the past seven governors elected in Illinois to be arrested!

Still, US equities are over-sold and some sectors of the market, such as technology stocks, are back to their 2002 lows. I was fortunate recently to attend an internal seminar of Intel. I must say that I was not only very impressed by Intel's CEO, Paul Otellini (a very humble person), but also by the many Intel employees I met. I predicted that Intel's stock would significantly outperform ten-year US Treasury bonds over the next ten years. It is reassuring to know that America still has some well-run, cutting-edge

Table 1 **Singapore REITs**

S-REITs	Year End	Last Price (S$)	Market Cap (S$m)	FY08 DPU (S Cts)	FY08 Yield (%)	FY09 DPU (S Cts)	FY09 Yield (%)	DPU Growth (%)	Price/ NAV (x)	Gearing (%)	Px Chg 3M (%)
Ascendas India Trust	Mar	0.43	332.4	7.1	16.5	7.3	17.0	2.8	0.4	5.0	–44.5
Ascendas REIT	Mar	1.36	1,781.7	15.7	11.5	16.2	11.9	3.2	0.7	41.4	–41.4
Ascott REIT	Dec	0.50	311.5	8.9	17.8	8.0	16.0	–10.1	0.3	34.9	–46.8
CapitaCommercial Trust	Dec	0.74	1,053.5	11.7	15.8	12.5	16.9	6.8	0.2	36.3	–57.7
CDL Hospitality Trust	Dec	0.63	525.8	11.2	17.9	9.5	15.2	–15.2	0.4	19.3	–47.0
Capita Retail China Trust	Dec	0.50	315.7	7.4	14.9	8.3	16.8	12.2	0.4	31.0	–50.5
Cambridge Industrial Trust	Dec	0.21	163.3	6.1	29.0	5.6	26.7	–8.2	0.3	37.6	–66.1
CapitaMall Trust	Dec	1.58	2,550.3	14.5	9.2	15.3	9.7	5.5	0.7	43.3	–44.0
Frasers Centrepoint Trust	Sep	0.49	357.3	7.7	15.7	8.0	16.3	3.9	0.4	28.1	–59.8
Frasers Commercial Trust	Dec	0.20	150.0	6.4	32.0	5.4	27.0	–15.6	0.2	48.6	–72.0
First REIT	Dec	0.38	102.6	7.3	19.2	7.3	19.2	0.0	0.4	15.6	–45.3
Fortune REIT	Dec	1.75	1,414.7	37.5	21.4	37.5	21.4	0.0	0.2	23.6	–55.2
K-REIT ASIA	Dec	0.61	404.7	10.5	17.2	8.6	14.1	–18.1	0.3	27.6	–52.3
Lippo-Mapletree Indonesia	Dec	0.275	299.2	6.5	23.6	6.1	22.2	–6.2	0.3	9.0	–52.6
Macarthurcook Industrial	Mar	0.28	75.7	9.3	33.2	9.1	32.5	–2.2	0.2	39.6	–64.3
Mapletree Logistic Trust	Dec	0.35	649.7	6.9	19.7	5.9	16.9	–14.5	0.4	36.9	–51.7
Macquarie Prime REIT	Dec	0.47	445.4	7.1	15.1	7.8	16.6	9.9	0.3	28.9	–55.2
Parkway Life REIT	Dec	0.80	478.9	6.9	8.6	7.6	9.5	10.1	0.6	19.7	–27.9
Suntec REIT	Sep	0.62	968.1	10.4	16.8	9.6	15.5	–7.7	0.3	31.9	–58.1
Saizen REIT	Jun	0.15	72.3	5.6	38.6	5.4	37.2	–3.6	0.3	43.1	–71.3
Average					**19.7**		**18.9**		**0.4**	**30.1**	

Source: Kim Eng Securities, Singapore

technology companies, and the purchase of high-quality tech stocks such as Intel (INTC), Cisco (CSCO), and Microsoft (MSFT) should be considered.

Beaten-down insurance companies such as Leucadia National (LUK) and CNA Financial (CNA) also have the potential to rebound strongly.

Mining companies (especially exploration companies) have been decimated over the last few months. Relative to the price of gold, gold mining companies are now incredibly inexpensive. And compared to the value of its assets, Ivanhoe Mines (IVN — I am a director) is extremely depressed. Another candidate with substantial upside potential and strong backing is Gabriel Resources (GBU CN). Among larger mining groups, CVRD (RIO), Rio Tinto (RTP), Newmont Mining (NEM), and BHP (BHP) should rebound. Personally, I continue to hold and accumulate physical gold.

There is a strong case to be made that corporate bonds and convertible bonds are far more attractive than US Treasury bonds, and possibly even more attractive than equities. As mentioned in last month's report, an investment in iShares iBox Investment Grade Corporate Bond (LQD) and Nicholas Applegate Convertible & Income Fund (NCV) is recommended (see Figures 21 and 22 of the December GBD report).

Asian shares, including Japanese shares, appear to be more attractive from a fundamental and technical perspective than US equities. Investors may play an Asian stock market recovery through a basket of ETFs or through some high-quality companies such as Swire (19 HK), Sun Hung Kai Properties (16 HK), Chunghwa Telecom (CHT), Fraser & Neave (FNN SP), SIA Engineering (SIE SP), STE Engineering (STE SP), Singapore Airports Terminal Services (SATS SP), OCBC (OCBC SP), UOB (UOB SP), Thai Beverage (THBEV SP), and Bangkok Bank (BBL TB) — just to name a few.

There are, however, two points that greatly disturb me concerning a global equities rebound. I'm not aware of any technical or fundamental analyst who doesn't believe in a stock market rebound. Therefore, it's possible that the oversold position of the markets will be solved by a sideward move and then renewed weakness and not a strong rebound! Moreover, there are dark geopolitical clouds on the horizon. According to the International Council on Security and Development (ICOS), the Taliban now holds a permanent presence in 72% of Afghanistan, up from 54% a year ago. They have advanced from their southern heartlands, where they

are now the de facto governing power in a number of towns and villages, to Afghanistan's western and northwestern provinces, as well as provinces north of Kabul. According to Paul Burton, Director of Policy for ICOS, "the Taliban are closing a noose around Kabul, and there is a real danger that the Taliban will simply overrun Afghanistan under the noses of NATO". And guess from whom the Taliban and other destabilising elements based in Pakistan and the Middle East get their weapons? Just take a look at a map of Central Asia: which country has a 2,000-mile border with Kazakhstan, Tajikistan, Kirgizstan, Afghanistan, and Pakistan, and which country in the north of Central Asia doesn't want to be encircled by US bases?

I struggle the most with the US dollar and with US government bonds. I find it hard to believe that someone would buy a 30-year US Treasury bond with a yield of just 3% as an investment. (I can understand doing so as a trade.) One of the "Big Trades" of 2009 will be to short Treasury bonds (short TLT) or to go long the UltraShort 20+Treasury ProShare (TBT). The upside of 30-year Treasury bonds would seem to me to be extremely limited!

As mentioned repeatedly in last year's reports, there is nothing "good" about the US dollar. However, the same can be said about other paper currencies of which many have even worse prospects. I have on many occasions explained that when Foreign Official Dollar Reserves (FRODOR) increase at a decelerating rate because the US current account deficit shrinks, the dollar tends to strengthen. Since I expect the US current account deficit to shrink much further (weak consumption leading to less imports and a shrinking trade deficit), the dollar should — following a correction on the downside — strengthen further. But this is not a high-confidence forecast, whereas my forecast that your children will be left with a totally worthless US dollar is a prediction of high confidence.

My friend Douglas Clayton has spent over 20 years in Asia, mostly in Thailand where he served as CLSA's chief representative and CIO of Knight Asset Management. In 2006 he decided that Cambodia offered much greater opportunity and relocated there to set up Leopard Capital, along with some former CLSA colleagues (including top-ranked economist Dr. Jim Walker), and other Asia specialists. Leopard Capital is the first investment management firm established in Cambodia, and by way of disclosure, I am a shareholder and serve as its chairman. Doug has kindly provided us with an update on economic trends in Cambodia.

Further below you will find a piece on the rise and fall of nations by Rony Teitelbaum (ronteitel@gmail.com), who humbly says that he doesn't yet have an impressive C.V. but who is a student of history and economics at Tel Aviv University. He discusses the theories of Giambattista Vico who, at the beginning of the 18th century, described in his book *The New Science* (*La Scienza Nuova*) an "ideal eternal history" in which nations perpetually pass through different cycles. It's well worth a read if you aren't feeling gloomy enough!

IMPORTANT NOTICE TO SUBSCRIBERS
This report is not sent out on the first day of each month and, therefore, you may not receive it until the middle or even the end of the month.

I am frequently asked by my readers who in Asia would be suitable to manage some money. My friend Khing Go runs Schroeder & Co. in Singapore. According to him, "Schroder & Co. (Asia) Limited is a unique family office private bank dedicated to client-tailored financial solutions to successful individuals and families around the world and have done so for over 200 years. Our focus is on growing and preserving wealth. Drawing on the experience of a pure open architecture, to provide a highly personal service to wealthy individuals and their advisers which even entails working with other private banks in order to facilitate client needs.

As a busy professional, it is often more cost-effective to delegate management of personal financial affairs to others. Commitment to excellence ensures the highest quality of service. To provide investment management and banking services to manage liquidity and reflect your strategies, leaving clients free to concentrate on their professional responsibilities.

Longstanding relationships with professionals across the wealth management industry mean that we are very used to working as part of a team to assist you in your investment responsibilities and help you to manage risk effectively."

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Update from Cambodia: Asia's Sanctuary of Opportunity

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As deleveraging decimates the world economy, the least damaged are the least developed countries like Cambodia that were left off the guest list of the global liquidity party. Cambodia now stands out by not standing on the brink of financial ruin or a looming "lost decade". The government's finances remain sound with just US$4 billion debt, mostly long-term concessionary loans from donors without rollover risk. Private sector borrowings reached only 20% of GDP last year; this is still a cash economy. The small, under-geared banking system continues to function normally and expects record profits this year. Phnom Penh's feared building boom bubble was artfully pinpricked before most planned projects broke ground, and Cambodia must be one of very few countries now with an undersupply of prime office and retail space.

The mood in Cambodia today is wary but not despondent. Local newspaper readers must turn to the international section to find any stories of fiscal stimulus packages or monetary easing or corporate bailouts. Cambodians have not suffered stock market losses, as almost no one invests in overseas markets and the local market's launch is still at least a year away. Cambodians with money hold their savings in super-strong US dollars, or in land that they mostly acquired years ago when it was dirt cheap. As for the broader population, 70% of Cambodians are subsistence farmers who worry more about rainfall patterns than far-away economic events; this year, a good harvest is expected.

Nonetheless, while Cambodia dodged the credit bullet it can't avoid the aftershocks of global recession. Its GDP growth will likely halve from 10% to 5% over the next two years as:

• **FDI** is tightening, especially from past leader Korea. China, Japan, and the Middle East are being targeted as replacement sources, but at best this may take some time.

• **Land** prices are tumbling, particularly in prime Phnom Penh areas, which tripled unreasonably in the last two years. Fortunately, the land speculation game was largely funded through cash and seller-financing, so the needed correction will punish the participants without burdening the banks.

• **Construction** is contracting as Korean developers lose Korean funding, and local presales dry up.

• **Garment** exports are stagnating, as most head for the battered US market. Some factories have closed.

• **Tourism** growth has slowed to around 8% in 2008 after 18.5% growth in 2007, and will underperform again in 2009. The border spat with Thailand, followed by the one-week closure of Thailand's international airport, have added insult to injury.

• **Rice, rubber, and cassava** export prices have corrected from their recent spikes, overshadowing output volume gains.

But in contrast to many countries, Cambodia's slowdown is unlikely to be protracted. The glaring gaps and overlooked opportunities in its pre-emerging economy will continue to attract venture investors, with incoming enterprises helping to offset the consolidation of incumbents. Note that the investment flows needed to jolt a US$8 billion economy are miniature even in sub-regional terms, and notwithstanding the global crisis, we continue to see overseas businessmen coming to scout Phnom Penh for opportunities. Stimulus will come organically from the private sector, rather than in sugar-coated form from the government. In the meantime, while some pain will be felt by existing Cambodian businesses, a period of slower growth does have some positive aspects, especially for newcomers with cash:

• **Inflation,** which climaxed alarmingly at 25–30% in June 2008, is now "yesterday's problem" as prices of oil, rice, building materials, and most other commodities have plunged. The IMF expects Cambodia's CPI to drop to 15% by year-end 2008 and to 7.5% in 2009.

• **Oil price** weakness reduces power generation and transportation costs.

• **Land and construction materials** price adjustments benefit incoming developers.

• **Forced exits** by some of Cambodia's existing foreign investors will create opportunities for new investors to acquire quality assets at distressed valuations.

• **Reduced competition** increases investors' negotiating leverage.

• **Cambodia's government** may feel pressured by the slowdown to try harder to improve its governance, efficiency, and regulations. By the next general election in 2013, over 12% of Cambodia's population will have reached working and voting age; new jobs must be created to maintain the government's popular support.

In the worsening global recession, Cambodia remains one of the world's few compelling investment stories, offering that now rarest of combinations, growth and value. As longtime Asia watchers, we have learned the risks of buying bombed-out mature economies lacking return routes to growth; Japan, whose stock market is hitting 26-year lows, provides a grim reminder that it takes more medicine than zero interest rates, stimulus packages, and bank bailouts to revive a comatose patient. Likewise Thailand, with its SET Index down 84% in US dollar terms over 15 years, reminds us to beware the value trap; cheap can always get much, much cheaper if the growth engine has missing parts. For us, the game now is about locating pockets of growth reacceleration.

We expect that Cambodia's unleveraged, underdeveloped, and continued "free-market" status will

make it one of the first economies to bottom out and then climb back to double-digit growth. Remember that Cambodia has already passed through a three-decade bear market, a catastrophic socio-economic collapse far more severe than what any Western country is now facing. Having finally emerged from that devastating experience, Cambodia is now equipped with some unique growth propellers to help it motor against the global current:

• **Diminishing risks**. Political risk erased Cambodia from the investment map for a generation; elimination of excess risk initiates a one-off catch-up trade. After delivering a decade of political stability and policy continuity, the Hun Sen government in July 2008 won yet another decisive re-election victory in a peaceful, internationally monitored election. Today, Cambodia is rated as less risky than India, Thailand, Malaysia, Indonesia, or the Philippines by the experts at Political and Economic Risk Consultancy Ltd. And confidence in Cambodia's future seems strongest among the Cambodians themselves, who for the past few years have been steadily repatriating overseas funds to purchase Cambodian property, an illiquid long-term investment.

• **Development help**. Cambodia's recent annual meeting with donors saw pledges of 2009 Official Development Assistance not fall as expected, but actually rise 35% to US$950 million, representing a whopping 11% of Cambodia's GDP. China has now become the biggest supporter, which makes it tough for other donors to reduce their contributions without ceding influence.

• **Breathtaking demographics**. Cambodia's labour pool expands by 4% each year — forcing growth as dependents convert into breadwinners. Think of the vast productivity and income growth that lies ahead for a country whose population has an *average age of 21*.

• **Talent transfer**. Well-educated overseas Cambodians (2 million live overseas) are coming back, joined by growing numbers of resident expat entrepreneurs, while foreign companies ranging from multinational corporations such as General Electric to private equity firms like ours are setting up shop in Phnom Penh. These steroid-like injections of experience and money into Cambodia's small economy are helping it to "leapfrog" from the 19th to the 21st century in some aspects, e.g. people going from no phone to 3G, or from candles to solar-powered lights.

• **"Nation-building" progress**. Remarkable progress has been made towards rebuilding Cambodia from its "Back to Year Zero" devastation into a normal country with functional institutions and a regionally comparable economy. The gap has narrowed between Cambodia and its ASEAN peers in fundamental areas such as legal framework, nationwide financial services, wireless communications, rural electrification, natural resource extraction, irrigated agriculture, primary commodity processing, import substitution industries, and the launch of local brands, products, and services. The progress is not even across categories, and much vital work remains to be done, but this catch-up stage is the "low hanging fruit" of a country's economic development and creates a virtuous cycle.

• **Transport connectivity**. A number of important road and rail projects are being undertaken to link Cambodian population centres to neighbouring Vietnam, Thailand, Laos, and ultimately China. Cambodia represents a small missing segment in the continental Asian Highway Network and Trans-Asia Railway projects intended to link Singapore, Malaysia, and Thailand to Southern Vietnam and then China, so it attracts donor financing for these projects from the Asian Development Bank and various governments, including China. Improving connectivity stimulates cross-border trade, investment, and immigration to utilise Cambodia's untapped natural resources, lower land and labour costs, and greater economic freedom.

• **Coastal transformation**. The recent expansion of Cambodia's third international airport, in Sihanoukville, is opening the country's 440 kilometres of beaches and 60 tropical islands to the world, potentially doubling Cambodia's tourism appeal and construction focus. Meanwhile, Japan has been upgrading Sihanoukville's seaport and building a nearby industrial estate, while Chevron continues to drill in the offshore oil and gas field. Sihanoukville will follow the example of Thailand's transformative Eastern Seaboard region, combining shipping, manufacturing, petro-related industries, and luxury resort hotels, spas, marinas, holiday villas, and retirement homes.

These growth catalysts will continue to keep Cambodia's economy moving forward, generating across-the-board opportunities for committed foreign investors over the years ahead. Basic industries such as agriculture, commodities processing, banking, power, and building materials offer attractive opportunities with relative safety, even more so if one takes a portfolio approach. Yes, global markets have collapsed and everywhere in the world now looks cheap. But, as usual, the best returns may be made in the places mainstream investors have yet to discover. See you in Phnom Penh.

Giambattista Vico Revisited and the Collapse of the Post-modern Economy

Rony Teitelbaum

In economics we tend to examine cycles. The Kondratieff cycle and the Elliot wave are examples of theories which attempt to generalise economic and market activity into a structured form, usually with some sort of repeatable characteristics.

In a similar manner, historians and philosophers have conducted research aimed at building a comprehensive theory regarding historical progress, and especially an examination and inclusion of the rise and fall of nations and societies.

The first scholar to introduce a general theory regarding the rise and fall of nations was the Italian philosopher Giambattista Vico (1668–1744), who described in his book *The New Science* (*La Scienza Nuova*) an "ideal eternal history" in which nations perpetually pass through a cycle comprised of three stages.

In order to properly understand Vico, one must consider the cultural and philosophical background from which his theory derives. Although Vico was a religious thinker, he incorporated within his own principles the eternal ideals from the Platonic world. He therefore stated his theory in abstract terms, presenting a perfect or ideal path which all nations must follow. In reality, of course, each nation travels along a slightly different path. He perceived this relationship between "ideal" history and the various "particular" histories to be identical to the relationship between cause and effect, between ideal design and historical reality. Although this historical identity common to all nations takes into account diversity in their development, Vico emphasised that, even allowing for diversity, a basic uniformity exists in the development of all nations.

Vico may well be considered the first historian to take into account the full complexity of the historical process. His explanation for the rise and fall of nations or, for that matter, any other historical development is based on a thorough understanding of the political, religious, moral, economic, artistic, and scientific environment of any given period. In his view, these elements are always interconnected and inseparable.

According to Vico, the three universal stages in the development of nations all exhibit characteristics unique to each stage, and these characteristics find their expression in the language, philosophy, art, religion, and laws of that period. The first stage is the "Age of the Gods". In his opinion, history begins after the "Flood", when society has lost everything: religion, law, language, and abstract thought.

Vico describes man's first method of thought as "poetic wisdom". This is to say that "primitive" thought processes are characterised by imaginative creativity rather than by discursive analysis, due to the fact that they cannot explain natural phenomena rationally. In this first stage, we witness the formation of the family structure, and of a primitive religion whose main purpose is to explain natural phenomena, primarily through the deification of a wide range of inanimate objects — from mountains, trees or rivers, to the sun or the moon. An aristocracy of elders is formed, who control others through religion. These elders rule over small communities and tribes. Basic laws are forged through the establishment of religion and by the authority of the elders.

The second stage is the "Age of Heroes". During this stage, the plebeians demand some of the privileges of the rulers, and the leaders of society are no longer "theological poets" but "heroes". These heroes show their strength by fighting each other and the plebeians for their own privileges.

The third stage is the "Age of Humans". In the previous stages, society is ruled by "poetic" wisdom which controls all actions through ritual. In order to undermine the power of these rituals, the plebeians now find ways to assert the power of conceptual wisdom, which is the ability to think scientifically and rationally. This type of thinking gives the plebeians greater power and releases them from the stranglehold that superstitious beliefs have on their society, resulting in a rapid development of science and philosophy. Unfortunately, whereas the plebeians are granted their freedom, the cultural unity provided by "poetic wisdom" is undermined. The religious inspiration to work for the common good rather than for the individual is now lacking. Society eventually splinters into a "barbarism of reflection". The "barbarism of reflection" is an atavistic barbarism whereby the common ties established by religion which bind society are now broken down in the pursuit of individual interests. These interests are spurred on by the fact that individuals act and think according to their own conceptual scheme with concern for society, this being barbaric behaviour. Philosophy becomes critical and sceptical, and the core values of society are weakened, its virtues undercut by a decadent and sceptical public no longer unified by the heroic ideals of the past.

Vico wrote during the Age of Enlightenment, a time when reason was considered by Western philosophy and culture to be the primary source and basis of authority, and a time aspiring towards centralised government and rights for the common people. He did not take a clear ethical position in regards to "barbarism of reflection", but simply described a historical phenomenon that he believed repeats itself throughout history.

Each age of barbarism ends with the establishment of a new religious

order, either voluntary or through conquest. Due to his religious beliefs, he maintained that in each successive cycle humanity more closely approaches the "true" Christian belief. In that respect, his cyclical theory is more a spiral than a circle. But even from a completely secular perspective, his theory remains intact. Clearly, a society needs some common set of values and rules in order to exist, and these cannot be derived solely by logical means. If the basic common values of a society are not derived from a religion, they can be found within that society's constitution or laws.

Vico's theory was designed to apply to any given society at any given time. So, we might try to apply it to present-day Western society. Since the time of Vico, the Western world has witnessed the most spectacular scientific, economic, cultural, and political changes ever. The bases for many of these changes date back to Vico's century: the French Revolution and the American Constitution resulted in the upheaval of existing political structures; Newton's discoveries in science had a profound effect on all mankind 300 years later; and the publication of Adam Smith's *Wealth of the Nations* laid the groundwork for unprecedented economic progress.

For those of us who conclude that we are presently witnessing the beginning of a dramatic shift of power in the economic and political structure of the world, with the balance of that power shifting to the East, it should be interesting to examine whether there are other signs pointing to this change, and the works of Vico can serve us as an excellent tool.

In order to do so, we should first examine Vico's case study — the Roman Empire — which clearly followed the patterns he described. With the weakening of the Roman Empire, the cultural environment became more decadent, the political structure more corrupt, and philosophy became detached from its intellectual base. A strong reinforcement of Vico's theory can be found in the philosophical experiment of Plotinus which was conducted in the middle of the third century AD while Rome was in political, economic, civil, and cultural turmoil. M. Cary describes these events in his book *A History of Rome*:

> …The Greek-Egyptian philosopher Plotinus revived temporarily the languishing theories of Plato. In particular his philosophy made an audacious attempt to solve the problems of good and evil, a question which other philosophies tended to avoid... However, Plotinus's teachings put too much emphasis on demanding intellectual observation from a generation which impatiently expected quick and obvious results... Plotinus's disciples converted Neo-Platonism to foggy, incoherent half-truths, which served as a cover for superstitious beliefs held by the general populace. Plato's elevation of the soul over the body through intellectual effort now became a pretext for witchcraft or magic. Popular philosophers dealt with the hermetic theory which mixed cosmogonist philosophical elements and magic, turning them into a murky mass of porridge… The ultimate failure of Neo-Platonism proved that philosophy could not cure the Roman world. Religion was the only hope for salvation from that earthly sickness.

And so the Roman Empire fell into civil, political, economic, and moral disorder, in desperate need of the establishment of a new political, religious, and economic order. It was only after Constantine adopted Christianity, transferred its capital to Byzantium, and established monetary reform that society became somewhat stabilised. Moreover, it was not until the time of Vico that Western civilisation once again became the dominant force in the world. This only occurred after ancient philosophical ideas were revived during the Renaissance and when the burden on science and innovation were once again removed via rationalism.

Vico's works can be seen as a warning sign for the appearance of social and political changes that came after the 18th century and its Age of Reason. One outcome of the Age of Reason was nihilism, which "generally asserts that objective morality does not exist and that no action is logically preferable to any other in regard to the moral value of one action over another". The 20th century introduced post-modernism, which in many cases "denies the very grounds on which western cultures have based their 'truths', these being: absolute knowledge and meaning, a 'decentralization' of authorship, the accumulation of positive knowledge, historical progress, and the ideals of humanism and enlightenment". The New Age spiritual movement combines aspects of "spirituality, cosmology, astrology, esotericism, complementary and alternative medicine, various religious practices, humanism, collectivism, nature, and environmentalism", and it is quite easy to make a comparison between this movement and the third-century hermetic theory.

Regarding the current financial meltdown, it is very clear that two main factors underlie the political reactions to the crisis, the first being pressure originating from ties between the financial and the political elite, manifested by taxpayer bailouts of large institutions that continue to deliver bonuses to the executives and donate to political campaigns. For those of us who are not blind, these are clear signs of political corruption which would have made the worst Roman emperor blush. The second factor is political pressure originating from the mass public. The kind of solutions offered so far, and I may add which were received with very warm enthusiasm, were tax rebates and gasoline tax holidays. These are actions aimed at a public who "impatiently expected quick and obvious results", to quote Cary's description of Roman society in AD 3.

In addition, it is clear that Western democracies, having made

great strides in improving civil rights for a vast population, now have to face the other side of the two-edged sword of democracy. Much like in Rome, political pressure from various groups of voters is preventing political leaders from making long-term decisions that would benefit the whole population, just as Vico describes.

From an economic perspective, it is arguable that many of these social phenomena are symptoms of a society that has long suffered from high rates of inflation. It is obvious that a society enjoying (or, for that matter, suffering from) easy money and easy credit for over 60 years and accustomed to quick wealth accumulation would therefore not have the patience to wait for long-term solutions.

On the other hand, it is also arguable that politicians in a society with deteriorating moral and political standards are easily tempted by short-term solutions, despite the knowledge that they will eventually make matters even worse. This is especially true if the public is short-sighted and lacks the intellectual discipline required to understand the root cause of the crisis.

In that respect, it is interesting to note that the Roman emperors began debasing Roman currency under the rule of Nero, which Vico asserted to be approximately the time that "barbarism of reflection" was beginning. This policy of debasement ceased only after the adoption of Christianity. Moreover, the first attempt to issue paper money, by John Law, was made during Vico's century, in an experiment which took parts of Europe rapidly back to a barbaric stage, if only for a short while.

We can also see that in the 20th century, the abandonment of gold — partially in the 1930s and entirely in the 1970s — coincided with nihilist and post-modern ideas. A society that sees all things as being relative and finds no intrinsic value in anything will find it easier to accept a system of floating currencies.

In fact, the advocacy for the so-called "new economy" can be seen as part of a cultural and philosophical environment. The notion that industrial production is no longer important, that the service sector is taking its place, that research and development, marketing or intellectual property are more important than capital expenditures, is based on totally illogical arguments. Comparing the movement from an agricultural economy to an industrial economy to the movement from an industrial economy to a service economy can be easily contradicted. The movement of labour from agriculture in the 19th century was due to improved methods of agriculture, not to the outsourcing of labour. It resulted in a huge trade surplus of agricultural products and not to an enormous trade deficit of manufactured goods such as the US and the Western nations face today.

In fact, one of the most amazing of things in the current crisis is that it happened in the midst of a revolution in the availability of knowledge. All the information regarding the unsustainable imbalances was only a mouse-click away, and yet the public and its leaders remained indifferent. This only proves that the social environment played a crucial role in the development of the mess we are in today.

It is clearly very difficult, if not impossible, to distinguish between cause and effect. Thus, it is not clear whether social changes came about as a result of loose monetary policies, or if a social environment enabled the abandonment of the gold standard. But if there is one point that Giambattista Vico has taught us, it is that in social and historical development all aspects of social life are interconnected.

THE GLOOM, BOOM & DOOM REPORT

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