Komorebi Invest Suisse

Le idee sono le nostre asset classes

Sand age

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Suppose you get up, one morning, and read in your favorite newspaper the following article*:*

"……….. Next week Mrs Lagardere will announce the beginning of new ECB's ***SAP program****. Under this program (that replaces all the previous ones) SAND (is just sand!) is purchased by ECB to address the risks of a too prolonged period of low inflation over the medium term.*

Sand will be bought at a minimum price of 10 euros per Kg and has going to be delivered to Silos, detailed in ECB web page, in 3 days since auction day. First Auction will be for 3000 tons of sand. The allotted placement is assigned to the bidders in proportion to amounts applied.

This brilliant idea (last Mr. Draghi legacy) is going to dribble the issue of the purchase of sovereign debt and the lack of private securities. ECB will be able to expand its balance sheet, giving to the system all the liquidity that the economy needs to grow. What a genius Mr Draghi, your legacy will deliver to economy 2,000,000 new cave companies only in Italy and Spain ; booming sales of lights cars and bins for transport; hundreds of new companies involved in transport and storage; a new construction cycle for silos where to put all the sand delivered to the buyer!

Not to mention the impact on services: food, transportation, entertainment, banking and insurance services.

A new era of prosperity and of double digit growth of GDP!..."

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It sound crazy? Are you smiling? Try to replace any reference to the sand with, for instance, terms related to oil industry.

"…..2,000,000 new drilling company only in Texas; the boom is sales of light vehicles and bins for the transport of oil (here finally start the cycle of credit!); hundreds of new transport and storage companies; …… Not to mention the impact on services: food, transportation, entertainment, banking and insurance services, subscriptions to Netflix.

A new era of prosperity and of double digit growth of GDP!..."

Changing the word sand with oil seems to explain very well what happened in the US shale boom thank to FED "money for nothing" QE. So don't smile if i'm ready to bet that Ecb will buy sand in the near future. For this reason i hope everyone will try to answer the following 6 questions. Only if everyone of us will try to understand effects on real economy of easy money we will be able to see how many mistakes have been made by central bankers and, believe me, those are to much!

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1. **Is investing 500 billion usd to extract oil at a cost of 60 or 70 dollars a barrel like caving sand ?** My answer : d*epends on the level of the oil price in the next 10/15 years; if it was going to stay permanently below $ 60, the answer would be yes. The mark to market of those 500 billion would be negative.*

2. **Which are second round effects, related to those 500 billion of investment?** My answer **:** *undoubtedly, positive! Estate agents, bars, restaurants, shipping companies, transport, enterteinement. It's named "induced growth". That means that GDP has certainly grown more than investments.*

3. **What happens to the induced growth when the investments impulse disappear and investments were non productive one?** My answer **:** *Obviously disappear!*

4. **If the "mark to market" of those investments is negative, which is the value of the corresponding liabilities (bonds or equity) that financed them?** My answer **:** *intrinsic value of the these liabilities is zero,*

5. **Last question can an Investment with a negative intrinsic value have a positive mark to market ?** *My answer : yes, its price on the market could be positive if there is a Central Bank put or an asset purchase program from a Central Bank.*

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What does all this mean? This means that, despite, in theory, intrinsic value of oil is higher than value of sand, in the real world, to drill oil at $ 70 a barrel may be equivalent to cave sand at 10 euro per kg.

Generally speaking, what I mean is that **<u>any increase in GDP achieved through an expansion of credit</u>** in order to finance:

- bad investments

  and or
- levels of consumption higher than disposable income (linked to disequality),

<u>is a in temporary and mean reverting increase</u>.

In fact you can be sure that decline in the marginal productivity of the system, together with the increase of the ratio debt / income, will bring back all the economy to the starting point. All items which had been benefited from the temporary increase would come back too (ASSETS, LIABILITIES and INCOME).

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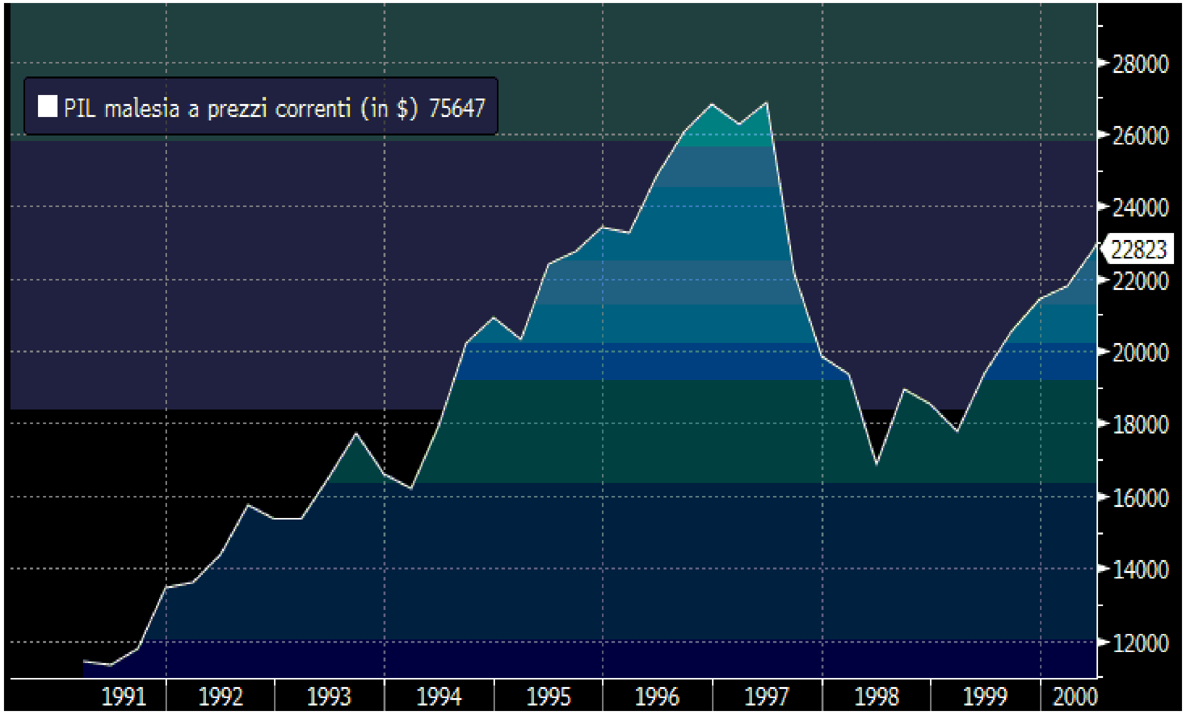
Here is what happens when an economy experiences an orgy of investment (or consumption) NOT BASED on AVAILABLE INCOME but on AVAILABLE CREDIT:



In the graph, the GDP of Malaysia. In the early 90s the country has experienced an orgy of investments. A crisis followed and erased nearly 2/3 of the increase of the GDP.

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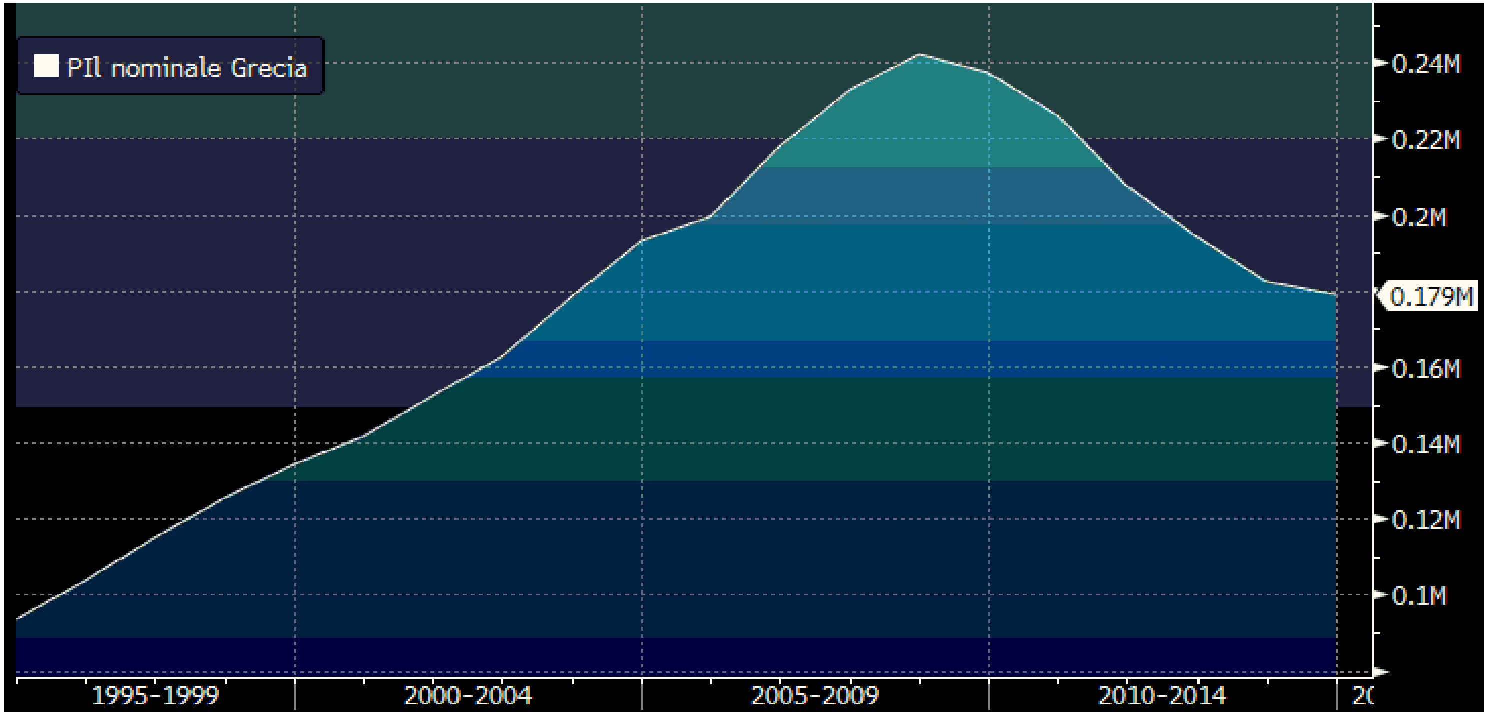
Is this example too long time ago? Look what happened to Greece 10 years ago. Since it is a Euro member, the country has seen a boom in consumption (public and private) due to the aboundant credit available (too much if compared to disposable income). The crisis that followed has erased, so far, nearly half of the increase of the GDP.



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Greece, Malaysia, the miracle of real estate in Spain and the USA, clearly show us what happens when Central Banks take away the value of the money and manipulate “time preferences” throught interest rates.

Even without buying sand, there are a lot of sneaky ways to remove value to money.

If a central bank prints money to buy assets without:

- **limits regarding beneficiary’s gender** (e.g.: the ECB buying corporate debt),
- **limits regarding amount** (e.g. the ECB buying <u>**30%**</u> or more of the existing stock of public debt),
- **limits regarding price** (e.g ECB buying BBB- bonds at negative rates)

You can be sure all conditions to start an ephemeral increase of the GDP are in place !

Without those limits, just the slightest mistake in the decision process of capital spending (e.g. mistakes in estimate long term demand) could lead to “negative marginal productivity” investments. Without those limits, it is easy for consumer to consider sustainable a level of debt that, actually, exceeds the real future dynamic of his income. Or, even worse, to consider Debt and Income as equal.

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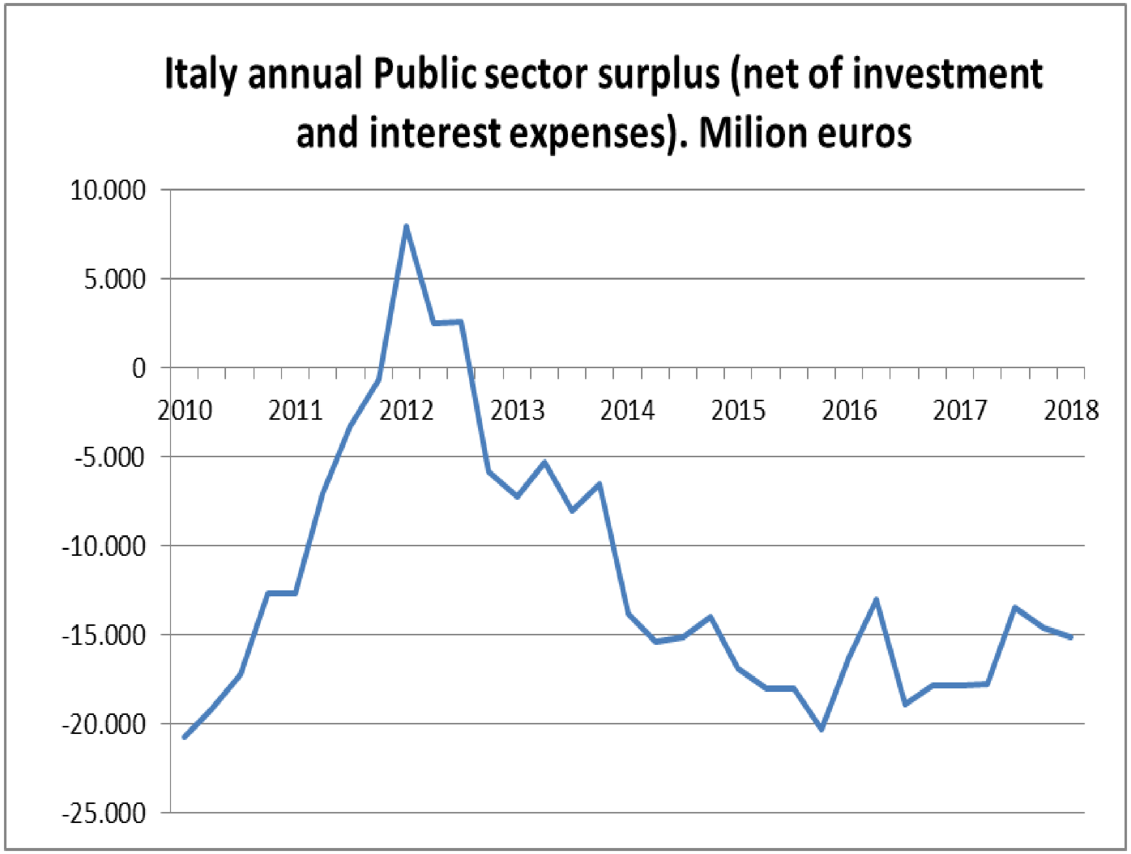
When Draghi bought BTP, what was he funding? Was he funding public investments (in an attempt to increase the productivity of Italy and therefore to promote more growth)?



The answer is in this graph. Excluding the decrease in public spending due to lower interest rates and fixed investment, the Italian public deficit has been steadily deteriorating since 2012.

<u>The debt continues to grow to finance current expenditures</u> .

Are We following Greece path of the early 2000s ? are we far just one recession from having the same ending.

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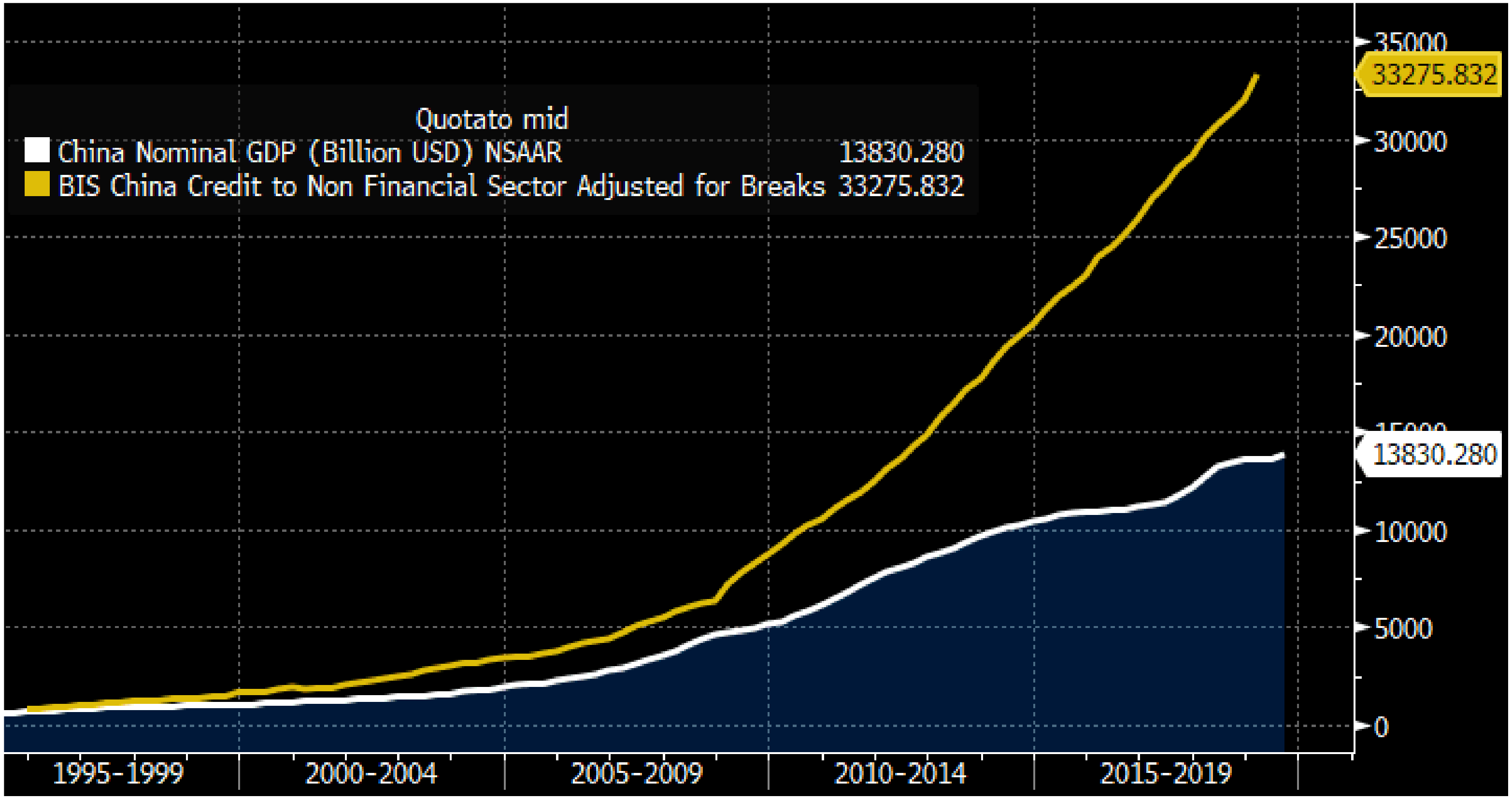
Do you like Draghi and his policies? Do you like a place were a Central Bank (or a government) has total control of economy? For sure you like China. So let me ask you same question about China. **Debt has been engine of China's growth. What has this debt funded?**



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Why chinese Total Factor Productivity, measured on the potential output, decreases so quickly from 2009 ?