

To: Oakmont Corporation

October 2009

From: Damon de Laszlo

DABERIAM LI

The beginning of the fourth quarter brings with it a rather surreal polarisation of economic thought. On one side the prediction that deflation is the greatest danger and that monetary authorities should continue to stimulate the economy. The deflationary argument suits politicians and bankers: the first are enjoying the largess of profligate Government expenditure and postponing the need to address the massive deficits; the second, who necessarily need to repair their balance sheets, can take advantage of loose monetary policy to make enormous profits. The deflationary argument is primarily based on two premise – first, that the high unemployment level will hold down wages, and second, the apparent availability of under utilised global manufacturing capacity. The argument is also bolstered by the convenient exclusion of food and fuel from most inflation calculations.

On the other side, the inflationary argument is premised on the phenomenon that the creation of excessive amounts of money by the Central Bank and the banking system will, over the long term, cause prices and wages to rise. The simplistic summary being too much money chasing too few goods and services. There is also a line of argument that relates increasing interest rates to rising inflation. Again, simplistically, if Governments go on overspending, their borrowing will drive up interest rates when the Central Bank attempts to tighten the money supply. Rising interest rates and Government borrowing crowd out other investments which makes it difficult for those that supply goods and services to meet demand. The present financial crisis is, however, already making it difficult for individuals as well as corporates to borrow. The downturn in the economy, as well as borrowing constraints, are causing bankruptcies and the destruction of productive capacity. As a side issue, it is likely that the rate of corporate bankruptcy will rise over the year end; in the retail sector this is the moment at which banks historically tend to foreclose as shops have sold their stock by Christmas and it's the moment when they have the most cash. In the industrial sector, as the economy starts to improve, companies are unable to finance their increased turnover causes them to breach their banking covenants.

The interesting thing about arguments that are polarised around two extremes is that they tend to create a simplistic list of apparent contradictions. The wide ranging thought goes out the window as each side lob simplistic statements at each other, while ignoring what is really happening around them.

Leaving aside technical arguments about deflation and inflation and looking around the world, it appears that prices being charged by Chinese exporters are rising as the Government encourages domestic expansion. It is also likely that the RMB will rise against the euro and the dollar as the Chinese Government is concerned about domestic inflation. Historically the West has been enjoying the benefits of “cheap” industrial and retail goods from China. Food prices are rising around the world owing to shortages, some caused by a lack of planting and fertilisers as farmers face financial constraints, and in other areas by bad weather conditions. Raw material prices are rising and the mining industry can only increase production slowly. In the same vein, oil at US\$70/brl. is historically high for the middle of a recession. It is likely that commodity prices will continue to rise as the recession ends.

Inventories around the world are very low and the global supply chain has been destocking, recently at a faster rate than the decline in end sales. The computerisation of the supply chain has meant that businesses are run much more efficiently and leaner than in previous recessions. This phenomenon is particularly visible in the US where increased productivity and profitability in the industrial sector has been maintained even as the economy has declined.

One can guess that nasty surprises will appear as these trends reverse. If lead times for your product in a downturn drops from eight weeks to four weeks, you only need to carry half your normal inventory. However when things pick up the lead times go from four weeks to eight weeks, you need to double your purchase requirement in order to double your inventory. This will give your supplier pricing power and also increase your need for capital.

At the moment the retail sector is carrying very low stocks - ask any shopkeeper. This implies that it is unlikely that there will be broad scale sales in the Christmas period, something that has driven down prices in the last few years.

It looks as though we are in for at least six to nine months of statistical economic growth which will not help employment, in fact unemployment will tend to continue on its rising trend. There is likely to be upward pressure on prices, and increases in taxation coupled with increases in personal savings. Somewhat bizarrely this is likely to be coupled with increased profitability in the corporate sector for well capitalised and well managed companies.

The prospect of continuing and possibly rising unemployment is likely to have serious social consequences, particularly in the UK where the next Government will also have to constrain the bloated public pay-roll, which will lead to industrial unrest. Europe is not likely to fare much better, whereas we can expect the USA and Asia to have brighter prospects as the Government takes a smaller slice of the GDP cake and China in particular has better control of its economic policies.

The good news is that improvements in stock markets are likely to continue as people wake up to the fact that holding cash is probably not a good investment over the next few years.