By John Mauldin

This week I write from Grand Lake Stream in Maine. It has been a long time since I have taken a week off from writing, but I think this is the week to do it. But that means, gentle reader, that you get an upgrade in quality, as my friends (thanks, Louis!) at GaveKal have graciously permitted me to use one of their most recent newsletters, where they talk about the recent inflation numbers, survey the markets in Japan and discuss Chinese growth and taxes. It is an interesting letter, and I trust you will enjoy it. I will return next week. You can find out more about GaveKal at www.gavekal.com.

Authors: Louis-Vincent Gave, Arthur Kroeber,
Anatole Kaletsky, Pierre Gave

Goldilocks or Micawber?

Which is the greater risk: inflation or recession? The markets may be struggling for an answer, but Ben Bernanke has made up his mind: he isn’t worried about either!

Just two hours before the semi-annual Humphrey-Hawkins testimony on Wednesday, the markets were hit by another disconcerting CPI figure, which showed core inflation diverge even further from the Fed’s informal target of 2%. Core CPI inflation is now 2.6% on a 12-month basis (compared with 2.1% as recently as March). The Cleveland Fed’s median index of core inflation has risen to 3.5% and headline inflation is at 4.3%. But Professor Bernanke is unperturbed and unrepentant. Far from qualifying the dovish tone of the June FOMC minutes Bernanke made clearer than ever his belief that the Fed should focus on the “longer-term outlook”, and attach pretty low significance to current inflation figures, which reflect monetary decisions made many months or years ago.

This “forward-looking approach” to monetary policy is perfectly reasonable, but it does present one crucial practical problem: by the time we know whether inflation in 2007 is 2%, 4% or 6%, it will be too late to do anything about it – and the Fed will have the same excuses for doing nothing about it as it does today. A purely forward-looking monetary policy sounds fine, but it can resemble the forward- looking approach to personal solvency immortalized by Mr. Micawber’s famous catch-phrase: “something will turn up”.

It is when we consider the "something" that might have to turn up (or down) to relieve America's inflationary embarrassment, that we start to worry about Mr. Bernanke's approach. Bernanke plans to reverse the upward trend of inflation without inflicting a painful economic slowdown on the American public: "The economy should continue to expand at a solid and sustainable pace and core inflation should decline from its recent level." The Fed's numerical forecasts bear out this Panglossian view. They show growth slowing only marginally to a range of 3.25- 3.5% this year and 3-3.25% in 2007 – very close to the US economy's potential growth rate (generally reckoned as 3% to 3.25%). And trend growth is not just a forecast; it seems to be an explicit policy objective, to judge by the key passage in Bernanke's oral presentation: "Clearly, we don't want to tighten too much to cause our economy to grow more slowly than its potential. We are very aware of that concern. We think about it. We look at it. We try to evaluate it."

This is an admirable objective. **But is it likely that the trend of inflation will suddenly turn downwards if the Fed does everything in its power to keep the economy growing at or above its potential rate**? After all, this implies that unemployment and capacity utilization will remain about where they are today? **Bernanke appears to see no contradiction in simultaneous commitment to price stability and robust growth**.

The markets now seem to be taking the same optimistic view, bidding up both cyclical assets and bonds. Could America move straight from inflationary overheating to a perfectly-balanced Goldilocks expansion? It could happen; the Fed has a great record of confounding the skeptics. The risks, however, are clear: either growth will slow to well below trend or inflation will continue to accelerate. Either outcome would now be a serious embarrassment for Mr. Bernanke and a disappointment to the markets. Worse still, the next few months could hit the Fed and the markets with a combination of both higher inflation and slower growth.

Did "They" Do "It" Again?

With the "they" being the Japanese policy makers and the "it" shooting any recovery in the foot. Let us explain:

As we never get bored of pointing out, structural bear markets and deflationary busts only happen when policy makers commit one, or several, of what we call the "five cardinal sins". The five sins are: 1. Protectionism, 2. Tax Increases, 3. Increases in Regulation, 4. Monetary Policy Mistake, 5. A War.

The common thread behind these five policy mistakes is that, when committed, they reduce the returns on invested capital and consequently, asset prices are pushed lower. And this puts the financial sector in trouble, etc…

Now why do we return to this long-held, and long-exposed, belief? It is not because of the failure of the Doha trade round (though that is a worry in itself). Instead, we return to the cardinal sins because they have proven to be a solid roadmap when navigating the treacherous Japanese financial markets.

Indeed, looking back at the past fifteen years, it often felt as if Japanese policy makers, if given half a chance, did their best to commit any, or all, of the above mistakes and shoot any recovery down. For example, in 1996, Japan raised taxes. In 2001, the BoJ allowed the growth rate of the Japanese monetary base to move into negative territory while the world was already experiencing a recession.

Which brings us to today and the recent announcement by a panel of LDP lawmakers of a plan to cut the maximum legal interest rates Japanese consumer finance and credit card companies are allowed to charge their customers from the current 29.2% to around 20%. This increase in regulation (which has taken the consumer finance companies completely by surprise), would likely cut off at least 9 million borrowers (out of the current 20 million) because the lower rates would make it unprofitable for consumer finance companies to take on the risk of the loans. A study by Waseda University cites that a restriction of the maximum interest rate to 23% would likely knock off 0.36% points of GDP. Needless to say, a restriction to 20% would make the economic hit even more dour.

Beyond the possible hit, there is also the threat that increases in regulation will help push more of the consumer lending underground, towards loan-sharks and Yakuza, and that the weakest consumers end up paying even more extortionate interest rates for the money they want. In other words, the LDP's good intentions could very well come to naught!

In any event, the threat of new regulations on the consumer finance industry, and thus on consumption is very real (the stocks have definitely taken it seriously). This is something that bears watching.

Corporate Profits & Rising Labor Costs in Japan

The recent weakness in Japanese equities (the Topix is down –10.3% so far this year) indicates that the appetite for Japanese assets is definitely falling. This is a marked change compared to the end of last year, when Japan was everyone's favorite market.

Over the past six months, we have suggested a number of possible explanations for this weakness, including the change in monetary policy (see *The Importance of Japanese Liquidity Flows*), the fact that Japanese companies could once again be placing market share over profitability (see *Japan's Capital Spending Boom*), the likely slowdown in global growth (our latest *Quarterly*) and even the possibility that Japan's policy makers are back to doing what they do best: nipping in the bud any recovery (see previous page). But there is yet another possible explanation for the weakness in Japanese equities: the fact that corporate profits are set to struggle because of rising labor costs.

In our past decade of following Japan, we have seen many age-old relationships break down spectacularly. One relationship that nonetheless remained solid was the one between Japanese corporate profits and Japanese over-time worked. And for a simple reason: A company facing a slowdown in sales (whether because of deflation or weak economic growth) can usually either: a) take the hit on its profit margins or b) maintain its margins and reduce its costs (i.e.: layoff some of its work-force and cut capital spending).

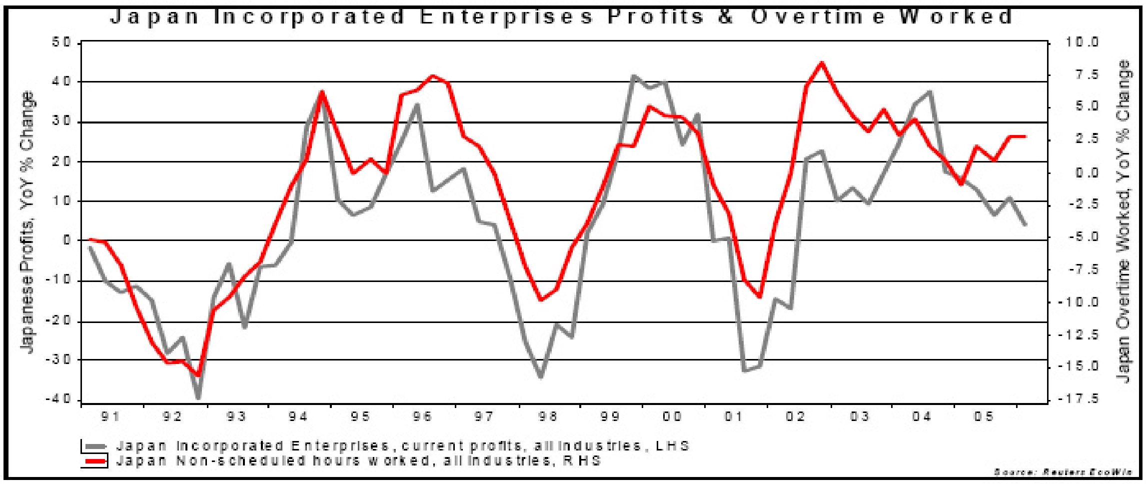
When Japan experienced its deflationary bust, laying off workers was simply not an option (because of institutional rigidities). Companies that faced a slowdown in sales could thus either cut capital spending (hereby jettisoning future competitiveness) or take the hit on profit margins. More often than not, the second option was chosen. Equity markets tanked and productivity sank. In turn, this meant that when the economy picked up, companies rarely hired new employees in the economic upswing (they already had all the employees from the previous cycle that they had not fired). And if demand accelerated further, companies would typically prefer to ask their workers to work overtime rather than increase payrolls (having just gone through the negative experience of excess payrolls). Thus, when we would see overtime accelerate, we could feel fairly confident that:

a) Demand in Japan was accelerating and
b) Corporate profits would pick up.

But in the past few quarters, this relationship has completely broken down. Overtime work has been re-accelerating (red line, RHS) while corporate profit growth is stuck in the low single digits and still decelerating. So why this breakdown?

The explanation might be found in Japan's increasingly tight labor market. Indeed, in the past two years, the unemployment rate in Japan has fallen from 5% to 4%. Now granted, this 4% unemployment rate seems high compared to the levels prevalent in the 1970s, 1980s or even early 1990s. But, since then, the Japanese economy has evolved from one where industry was the main driving force of growth to one where services are increasingly the new job creators. And in an economy driven by services, the minimal unemployment rate might be somewhat higher than in an economy driven by industry.

With that in mind, the Japanese labor market might be tighter than it would appear at first glance (a possibility which would help explain the BoJ's tightening). The recent rise in Japanese wages (wages had been declining for four years), also points to an increasingly tighter labor market. With a tight labor market, companies might be asking employees to work overtime not because they want to… but because they have no choice if they want to keep up with demand. Will this be good news for corporate profits? Over the long term, it should. But in the short term, disappointments might be around the corner.



Dragonomics Brakes Down China's Growth Numbers

China's growth continues to power ahead; but there is little evidence of a blow-out. The much-advertised "real" growth rate - 11.3% in Q2, a full point higher than in Q1 – is only as real as the deflator used to calculate it. And the latest deflator is decidedly dodgy. The National Bureau of Statistics (NBS) would have us believe that the GDP deflator slowed from 3.5% in Q1 to 2.9% in Q2, even though every other price index showed an accelerating trend during that period. This is most implausible.

Nominal GDP figures suggest that while growth has clearly accelerated over the past nine months, the acceleration is more modest than suggested by the "real" numbers. This interpretation is supported by growth in electricity production (one of our favored proxies) which, though somewhat volatile, is on a moving-average basis, still hovering around its 2005 average of just under 13%. Import growth (a significant indicator of domestic demand) has also clearly peaked and is now trending downwards.

Even at their current exalted levels, both nominal GDP and fixed asset investment growth remain well below their stratospheric highs of 2003-04. We suspect that the trend of headline GDP growth will be a bit hard to read for the remainder of the year, in part because there has been a change at the top of NBS. The old commissioner, Li Deshui, who appeared allergic to reporting GDP growth in excess of 10%, was axed over Chinese

New Year. His successor, Qiu Xiaohua, appears more comfortable with reporting high growth rates, so the high numbers reported today and in April may in part reflect an effort by the new regime to bring physical and statistical reality into closer alignment. Nevertheless, the dodgy deflator also suggests another, more depressing interpretation: apparent growth is being maximized now, to make it easier to report a slowdown in H2, thereby vindicating government policy… Having said that, the big picture is that growth is very strong and likely to remain so for another 12 months, underpinned by strong fixed-asset investment growth, a swelling trade surplus, and a very impressive surge in industrial production.

Investment, we think, is being pumped up by local officials anxious to make a good impression before the next round of promotions in the middle of next year, leading up to the big Communist Party Congress in the fall of 2007. This type of investment is likely to begin tailing off in Q1 next year.

On this logic of a likely structural downturn next year, the government will want to be careful about the risk of overshooting on monetary tightening this year. Hence we anticipate no further hikes in interest rates or bank reserve ratios until the impact on credit growth of the most recent reserve-ratio increase – which only took effect in early July – is clear. There was some evidence of deceleration in loan growth in June and if this continues in July and August then there will be little case for additional tightening.

Aside from loan growth, the other numbers that bear watching are price indices. These all steadily declined from mid-2004 highs down to a trough in late 2005. Since then they have all picked up again, with the exception of the manufactured GDP deflator. The swiftness with which the previous trend was reversed suggests that the economy is running at very close to full capacity. If the policy stance is correct, then price indices (which are calculated on a year-on-year basis and so will continue to bulge on a low-base effect) should continue to rise moderately until about November and then crest. If, however, the authorities have underestimated the strength of demand, then we could see a severe inflationary spike in early fall which could prompt another interest rate rise.

Figure 1. Key indicators, 2004-2006

% growth (nominal except where noted), 3mma

	2004		2005				2006	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
GDP, nominal growth, %	16.3*	16.6*	14.9*	14.2*	13.7*	14.0	14.1	14.5
GDP, real growth, %	9.1*	9.5*	9.9	10.5	9.8	9.9	10.2	11.3
Industrial value added (real)	15.8	15.0	14.5	16.5	16.2	16.4	18.1	18.0
Electricity production	11.9	14.0	13.4	13.3	13.2	11.7	14.7	12.5
Fixed asset investment	27.7	26.6	22.8	25.4	26.1	25.7	27.7	29.8
Fixed asset investment (real)	-	18.1	20.6	23.3	24.1	23.7	27.3	na
Exports	34.8	35.7	35.0	30.9	29.3	22.2	26.2	24.1
Imports	30.6	30.8	12.5	15.4	19.8	22.2	25.4	18.6
CPI inflation, % (end-quarter month)	5.2	2.4	2.7	1.6	0.9	1.6	0.8	1.4
Raw materials inflation, %	13.7	12.0	9.7	9.0	7.1	5.0	6.2	6.6
Implicit GDP deflator, %	6.2	6.5	5.0	4.3	3.9	3.8	3.5	2.9

*Quarterly real GDP figures for 2004, and nominal GDP figures through Q3 2005, have not been revised in accordance with the recent economic census revisions of full-year figures, due to lack of revised intra-year data. On average, both nominal and GDP growth rates should be raised by about 0.5 percentage points.

Hong Kong Adapts to the Brave New World

One of our favorite anecdotes about Hong Kong dates back to 2003, when the S.A.R. was mired in doom and gloom (property prices were down –70% from their highs, people were hysterical about SARS…). That year, taxi drivers went on a strike to ask for… lower cab fares! The logic was that, at a lower price, more people would ride taxis (the government refused on the premise that the cabs would then start competing with the buses, tramways & MTR). If nothing else, this story illustrates HK's amazing power of adaptation and "can do" attitude.

In recent days, we have been reminded of Hong Kong's power of adaptation as the territory starts a debate on whether to lower income tax rates, and introduce instead a goods sales tax (GST). Unsurprisingly, as the debate shapes up, precious few commentators fail to mention that, should Hong Kong adopt such reforms, it would be adopting a new tax regime of "tax breaks for the rich" and "new taxes for the poor". But of course, this misses the more important point, namely that the HK government is adapting to the new economic realities.

In *Our Brave New World*, we wrote that one of the implications of the platform company model is that industrial jobs in the creative world disappear, only to reappear in Mexico, China, etc... Over time, the job market in developed economies moves to a minority of very creative individuals who work for themselves, and a majority of fellows who work in the service industry for the creative minds and/or the tourists coming in from the industrial world (this, of course, is a left wing politicians' worst nightmare, if for no other reason that their political parties all rely heavily on trade unions and organized labor for their funding, and to bring out the votes on election day).

And this is where it gets interesting: once the switch to the platform company model is made, companies usually realize that they should domicile their research and marketing activities in countries with low marginal tax rates.

Take the financial industry as an example: on any given day, the biggest foreign net buyer or seller of US Treasuries is the Caribbean Islands. Now needless to say, the Caribbean islanders are not amongst the world's largest investors; but the hedge funds domiciled there most definitely are. So the 'efficiency capital' of the world which used to be domiciled in big investment banks, in the world's financial centers (whether London, New York, Frankfurt, Tokyo…) has now re-domiciled itself in hedge funds whose legal structures are in the Caymans, Bermuda, the British Virgin Islands, etc… The tax revenue on the 'efficiency capital' is now lost for the US, the UK…; and there is little they can do to gain it back.

As an increasing number of companies move to the 'platform-company' model, or as people leave the big companies to work for themselves or smaller entities, it is likely that the top talent will want to work (or at least be taxed!), in low tax environments. This economic reality should lead to a structural decline in tax receipts in the countries which do not adjust to this new model. In the new world towards which we are rapidly moving, **income taxes will becoming increasingly voluntary and governments will have to get**

their pound of flesh through property and consumption taxes instead. This is good news. Over time, it should lead to more efficient (i.e., downsized) governments all over the Western World. The platform company business model should end up killing off the Welfare State.

In the ‘first wave’ world, governments provided subjects a modicum of Regalian functions (police, army, judges). With the second wave, governments started to branch out and provided citizens with income redistribution, education, pensions, healthcare, unemployment insurance, etc…But in the ‘third wave’ world, will governments still be able to provide “prosumers” with all of the above services? How will they pay for them? In the ‘third wave’ world in which platform companies operate, taxes will increasingly become voluntary. Governments will thus have to compete with each other to provide the best services at the lowest possible costs to attract the world’s best platform companies, and their workers. Over time, this should mean that governments which provide the most efficient Regalian functions, and at the lowest costs (Hong Kong? Singapore? ...) stand to survive in their current structures. Hong Kong is adapting to this economic reality. And that is great news for the local economy. We remain bullish on Hong Kong assets.

Art, Wine & Horses

One of the recurrent themes of our research has been that it has “never been so expensive to be rich” and that this situation will only likely deteriorate. But even with that in mind, we have to admit that we have been floored by the recent activity at the high end of the market. Take wine, art & horses as examples. As most of our readers will know, modern art, fine wines, & horses, are assets that tend to peak just before the start of a pronounced downturn of the economic cycle. And interestingly, over the past couple of months, these assets have really been shooting up, breaking several records on the way:

? **The US$16 million horse.** A few months ago, a two-year-old colt who has yet to run a race drew a world record sale price of US$16 million at an auction in Florida, after a furious bidding war between Englishman Michael Tabor and Sheikh Mohammed bin Rashid al Maktoum of Dubai (could he be thinking that horses will run better than Dubai stocks?)**.** The sale broke the previous record of US$13.1 million paid in the mid-1980s for Seattle Dancer. Considering that very few horses ever reach winnings of US$1 million and that the all-time leading earner, Cigar, took home close to US$ 10 million, this is a truly mind-boggling price to pay for a horse that has yet to race a single race (incidentally, Seattle Dancer, the previous record holder, went on to win a paltry US$150,000, racing only five times in his short career).

? **The unbottled 2005 Bordeaux.** In the world of wine investments, Bordeaux is king, with up to US$3.7 billion worth of wines changing hands every year. Over the past twelve months, much to Charles’ chagrin (who likes to say that he is now too old to drink cheap wines), the price of top vintages have surged more than +45%. Much of this latest rally can be attributed to the - yet to be bottled - 2005 vintage. The 2005 vintage from some of the top chateaux are reportedly selling for around US$9,000 per case; as a comparison, in 2003, the same wines went for about US$3,800 per case... While investing in wine can be a very risky business, there is one undeniable advantage: if all else fails, it is a liquid asset…

? **The US$135 million portrait.** A few weeks ago, Robert Lauder bought a portrait by Gustav Klimt for a staggering US$135 million, the highest sum ever paid for a painting, eclipsing a Picasso sold for US$104 million in 2004. While we (by no means) would pass for art connoisseurs, prices do seem to have reached stratospheric heights. In his latest *Gloom Boom Doom* report, our good friend Marc Faber, describes his visit to the June Basel Art Fair, where one pure black canvas had a price tag of US$1.5 million…

Now interestingly, while the price of the finer things in life has skyrocketed, the company that handles their sales appears to have rolled over. Since its highs in early May, Sotheby's has lost a cool –25%. Is this the shape of things to come? Is the recent frenzy in the world of "finer things" another indication that we are at the top of the cycle. Usually, the last thing to go up in prices are rare automobiles. But then again, as George Best once said: "I spent all my money on cars and women. The rest, I just wasted".

Maine, Fly Fishing and Those #$%@# Yankees

The Yankees are in town next week, and daughter Tiffani is working on a party or two at the office. George Friedman of Stratfor is coming up, along with some other friends. It should be a lot of fun.

Trey (#3 son, 12 years old) and I flew into Grand Lake Stream on a float plane this morning (Thursday). It was his first trip in a small plane, and fortunately it was smooth flying. He is ready to do it again. We go out fly fishing tomorrow with a local guide to show us the ropes and the best spots, so we will see if he can overcome my life long ability to drive fish away from wherever I am. I am serious. It has been uncanny. There have been people who wanted to throw me overboard so they could catch something.

I come home on Sunday, and for the first time in decades, I have no where to go until January. Almost six months at home, where I am cranking on my next book. I intend to get it finished in November, and Wiley is going to power it through and have it out in the early part of 2007. If all goes well.

I am debating what to do about footnotes. More and more writers, (and some very serious ones at that) are not using footnotes in the text, but put them in the back of the book with page numbers, so you can look up a source if you want, but the footnote does not slow the reading process. I am not sure what I think about that. It does make reading quicker, but I am very sensitive about wanting to make sure that ideas and copy are properly sourced. If you have an opinion, let me know.

And now, Trey is telling me to get my swim suit on so we can hit the lake. I see some R&R in my future, and a little wine. The 20 or so economists, money managers and financial types have shipped in what looks to be over 100 bottles of wine. It should be a very happy crowd.

We will see if there are any fish that will end up on my hook. Who knows, if the market can rally off of Bernanke's statements, maybe I can get a 4 pound bass. Have a great week.

Your hoping my son gets the four pounder analyst,

John Mauldin