

From the Editor....



INSIDE THIS ISSUE

Market Update

*US Dollar
Carry Trade*

*Interest Rates
Rise*

Market Update

The very clear trend all around the globe in the first two months of 2010 has been disappointing retail sales and consumer confidence data. That includes Australia where crucial Christmas retail sales were lower than expected at the headline level, while retailer margins were also lower than expected.

Considering most global stimulus has been targeted at households and consumers, the data suggests that we are starting to see stimulus fade as the "hit" starts wearing off.

The stimulus addiction was confirmed by recent market action in the US. Fed Chairman Ben Bernanke uttered the words "extended period" and all the carry traders cheered for a day (borrowing at next to zero interest rates in the US and buying any asset class). But here is the problem. The Fed Funds Rate (FFR) is at zero. It can't go lower, yet despite the FFR being 0% US banks continue to reduce overall available credit. Last year US banks reported their sharpest fall in lending since 1942. Besides registering their biggest full-year decline in total loans outstanding in 67 years, US banks set a number of grim milestones. According to the FDIC, the number of US banks at risk of failing hit a 16-year high at 702. More than 5% of all loans were at least three months past due, the highest level re-

corded in the 26 years the data has been collected. With shrinking credit in the US and globally (ex Australia/China), the question has to be asked whether zero interest rate policy is actually helping households? The heavy fall in US consumer confidence figures lately would suggest not.

Recently the Bank of England Governor Mervyn King said that the Eurozone recovery has "stalled" while the UK risked a double dip recession and the Bank of England may need to reinstate quantitative easing measures. We remain of the view that the UK is the biggest basket case of all and that the Pound is going to remain under tremendous pressure.

Our cautious stance this year has been based around the fact we believe that governments have no more stimulus bullets to fire. If they keep spending they risk currency and bond market destruction. We also believe, while technically not possible, that central banks are broadly out of bullets and may even make the mistake of premature tightening of policy, misreading stimulus driven data as a genuine recovery.

The main problem we see here is the desperate situation that sovereign balance sheets are in at present. In our opinion this must lead to a period of very slow global first world growth or even the dreaded double dip recession which cannot be ruled out. What we now expect to see is unexpected tax rises and spending cuts, both of which

will reduce global growth. This is clearly already starting with all sorts of taxes and budget deficit restraining programmes being openly considered. That includes Australia (royalties, Henry Tax review, National Broadband Network, Emission Trading Scheme etc). Regulatory and legislative risk remains high around the globe.

The way we see it is we either have a genuine first world bond and currency crisis as politicians are unable to resist the temptation to spend, or we have genuine legislative restraint which will stifle growth. We just can't see how this recovery, from the worst global financial system meltdown in global history, becomes self-sustaining in the short-term, particularly given the one economic bright spot in the world, China, is also now showing cracks.

The more we read about Chinese bank lending and Chinese mainland property prices, the more we are tending to side with the Jim Chanos view of the world that Chinese property investment is the biggest bubble in the world. Chanos is a hedge fund manager and was among the first to predict the demise of Enron. He believes that China is "Dubai times one thousand—or worse". It seems pretty clear that Chinese bank lending in late 2009 was out of control in both provinces and individuals. We can understand why Beijing has clamped down hard on the mainland banks because it appears now short of capital and you can see they are starting to tap equity markets for new capital.

Make no mistake, we are extremely concerned about the current situation in China. We just don't like what we are reading and hearing, yet we still see universal belief in the Chinese growth story from investors and analysts. Don't get us wrong, we are a long-term believer in the China urbanisation story, but in the short-term we are more and more concerned the economy is overheated, particularly in

the property and provincial infrastructure construction sectors.

US Dollar Carry Trade

We believe the US dollar uptrend will continue as the 'least worst' major currency, while as economic data disappoints and China gets questioned, carry traders will have to question themselves about owning all these global cyclical stocks if economic growth just isn't happening. Therefore, there remains a very large chance of the carry trade being reversed, but I think people continue to underestimate the actual size of the carry trade.

At the World Economic Forum in Davos in January, Zhu Min, deputy governor of the People's Bank of China, spoke openly about his biggest fear for global financial markets in 2010. "To me, the big risk this year is the dollar carry trade," he said "It is a massive issue. Estimates are that the dollar carry trade is \$1,500 billion—which is much bigger than Japan's carry trade was." His fear was that the carry trade might start to unwind, pushing the US dollar higher and derailing the rally in asset markets that has accompanied the global economy's emergence from the financial crisis.

The Financial Times summarised the renewed strength in the US dollar as well.

The first part of the dollar's recovery seemed to be related to year-end position adjustment. Then forces emerged at the start of the year that have extended the dollar's gains.

First, China responded to an explosion of new bank loans in early January by allowing bill rates to rise and twice raising bank reserve requirements. This sparked a wave of profit-taking on commodities and emerging market equities, which in turn required investors to buy back the financing currency, the dollar.

Second, Greece's fiscal problems exploded and exposed a fissure in the foundation of European Monetary Union, causing some to question the very existence of the euro. This has weighed on the single currency and helped spur the dollar higher.

Now, a surprise move by the Federal Reserve last week to raise its discount rate, the emergency rate at which it lends to banks, has raised fears that US interest rates might rise quicker than expected.

When the Yen carry trade imploded there was carnage everywhere. The Australian market got hammered and anything cyclical and risky was sold down aggressively—BHP fell to \$20.00 at that time. It turned out the Yen carry trade was pricing everything, and when it unexpectedly reversed there was total mayhem. The speed of this mayhem caught most people off guard.

You can play in crowded trades but you must know when to get off the bus. We feel the time to get off that bus is when it becomes overcrowded and starts deviating from its expected route. That is right now in the US dollar carry trade and in the shorter term we remain very cautious on carry trade beneficiaries.

In summary, this remains an extremely difficult period for markets. To be honest, we have never had less clarity as to what is going to happen next. On that basis, we have to maintain a conservative strategy for the time being as we believe it will prove to be the right strategy in these uncertain times.

RBA Raise Interest Rates

The Reserve Bank of Australia (RBA) raised the benchmark cash rate from 3.75% to 4.00% during their meeting on March 2nd. Markets are predicting there will almost certainly be another ¼% rate rise in the next couple of months.

But after that, RBA interest rate decisions will get much tougher and the chances of

over-shooting are considerably high. Lifting interest rates ½% achieves two Reserve Bank objectives.

The banks have reportedly incorporated a ½% rate rise into their repayment sums. But after that, interest rate rises become very dangerous and a 1% increase would begin to bite hard.

The first RBA objective in lifting rates is its normal reaction to an overheated property market and the dangers that presents to the Australian economy.

But there is a second reason. There are a lot of potential global nasty events ranging from a big rise in the cost of capital driven by high government borrowing, to a collapse in the euro, to a significant China downturn.

If any one of those events took place, and Australia was expanding at too fast a pace, the blow to this country would be devastating. So, the RBA wants to slow us down without giving us higher repayment headaches on debt.

If the housing market is still roaring after a ½% interest rate rise, the RBA will need to consider moving into high risk territory and over shooting. Of course if the banks tightened lending and stopped hosing the housing market with money it would make the interest rate decisions much easier.

Information in this Newsletter is drawn from various sources, including extensive and comprehensive research by FN Arena, Bloomberg and the local press.

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