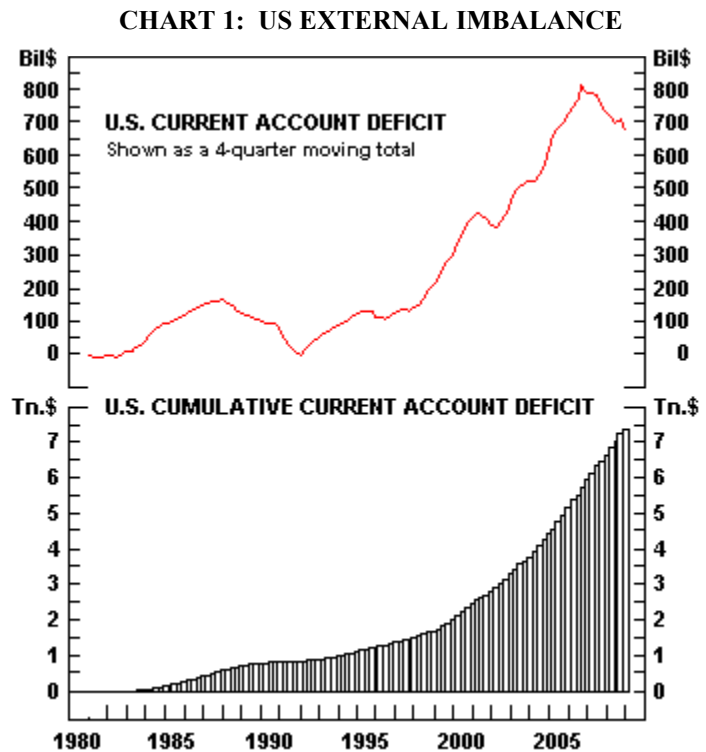


Life After the G-20 Meeting

Some Background

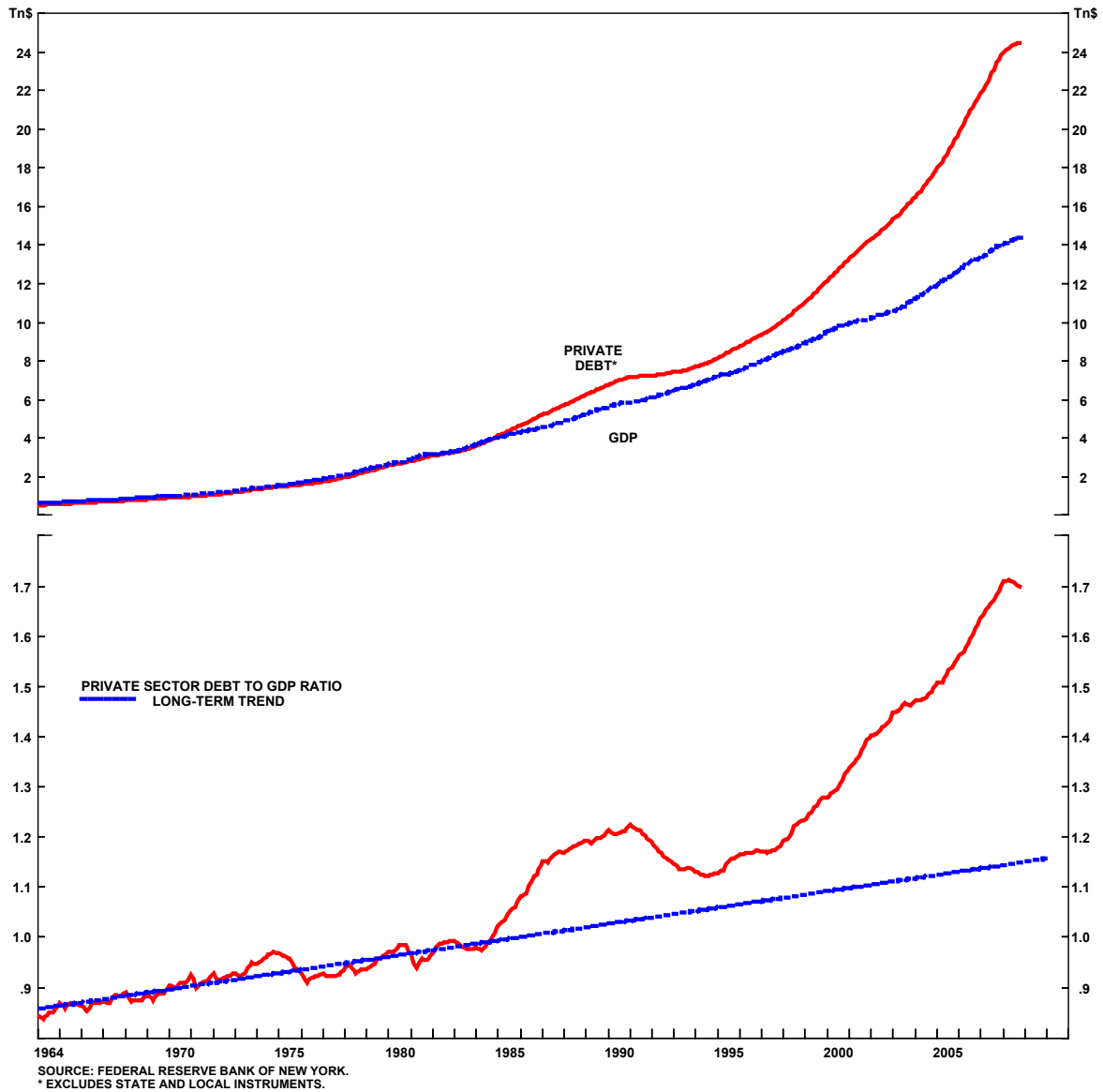
The underlying cause of the credit meltdown and near-collapse of the global banking system was the deeply flawed international monetary system. This enabled the US to run large and persistent current account deficits since the mid-1980s (Chart 1). This in turn allowed credit at US financial institutions to expand at a pace which was not only unsustainable, but put



many millions of families and firms in totally untenable debt servicing situations (Chart 2 - *next page*). They spent substantially beyond their means over many, many years, which is the counterpart of the collapse in US savings.

This dynamic has left the US, as a country, massively over-indebted to foreigners who have acquired a huge net claim on the US, which represents the foreign financing of US overspending.

CHART 2: THE DEBT OVERHANG



So, we are left with US residents over-indebted to their financial institutions and the US, as a country, over-indebted to foreigners. While the former – US borrowers and lenders – are being bailed out on a grand scale, the debt to foreigners is another matter entirely. In particular, as

Chart 1 also shows, the cumulative US current account deficit since the mid-1980's, now totals \$7.5 trillion and is climbing at the rate of \$700 billion per year, down from \$800 billion recently.

Without going into complications, there are a variety of capital flows into and out of the US, including direct capital investment, portfolio investment in bonds and stocks, trade finance, etc. These two-way flows need to be netted to get a more accurate picture of the external balance sheet of the US. It is not pretty. Chart 3 (*next page*) shows that the US has been a large and rapidly growing net debtor, currently (end of 2008) to the tune of about \$2.9 trillion, a figure that should probably be increased significantly because of the recent rise of the dollar and sharp decline in the value of US-held corporate assets abroad. Meanwhile, it must be recognized that a great proportion of the foreign claims on the US are in callable liquid form – cash, short-term deposits, Treasury and Government guaranteed bonds, etc. The assets on the balance sheets are long-term and not easily marketable (e.g. plant and equipment).

Therefore, from a balance sheet perspective, the US looks dangerously illiquid. And, from a solvency point of view, being a very large and growing net debtor has not been very comforting for a long time, particularly now with multi-trillion budget deficits currently and ahead.

This brief sketch highlights a key characteristic of the global monetary system which formed the backdrop to the April 2 G-20 meeting. And it obviously has to be viewed in the aftermath of the bursting of the speculative credit bubble, and all the artificial economic activity that was built on the bubble. This includes, for example, millions of new homes in the US and many parts of the world, millions of new Chinese factories to supply US over-consumption, millions of new condos, hotels and retail malls in China and elsewhere. The US consumer - driver of all this investment - is now in retreat.

The G-20 Meeting

The G-20 meeting was a success in that everyone showed up, major disagreements were

temporarily buried, and the

targeted villains on the agenda -

defective financial regulation and

inadequate IMF lending

resources - were dealt with.

However, the former -

incompetent regulation - merely

assisted in the creation of the

credit bubble, while IMF

illiquidity became a problem

only after excessive liquidity

from the flawed international

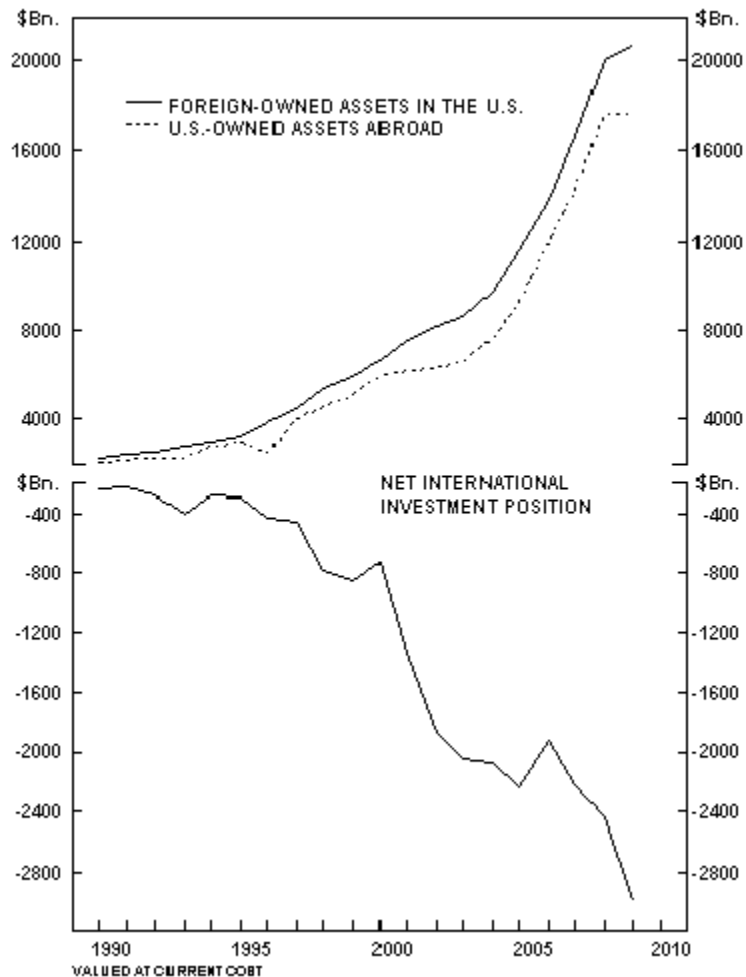
monetary system had inflated

credit prior to its collapse. That

in turn triggered the developing

world liquidity and solvency crises.

CHART 3: US NET INTERNATIONAL INVESTMENT POSITION



The real cause of the monetary disorder was not discussed at the G-20, other than very indirectly

by China. Eager to strut its growing clout on the world stage, China raised the indelicate question

of the reserve currency role of the dollar, arguing that the IMF should take over this role through

the creation of SDRs.* The extraordinary benefits accruing to the US from the dollar's role will not continue indefinitely. However, assuming the American consumer can be coaxed back to the malls, the benefits for China of supporting the dollar above an equilibrium rate will continue to outweigh the risk of losses on its \$2 trillion of reserve assets. Indeed, public confidence in the regime will depend, in the short term, on preventing excess unemployment, a particular concern in the collapsing export sector.

Significantly increased financial regulation will cut back on some of the most egregious practices that were the proximate cause of the current crisis, but cannot be expected to affect the destabilizing influence of sustained US payment deficits.

Expanding the IMF's ability to issue special drawing rights, billed as a first tentative step to reduce the centrality of the US dollar, will certainly be a non-issue for years to come. It would involve highly complex negotiations and would be greeted with great hostility by the US, which can be expected to ferociously guard its inflationary proclivities. An expanded availability of an alternative reserve asset, if it were to happen, would not change the behaviour of surplus nations very quickly.

The Chinese and other surplus nations must, of course, accumulate substantial reserves in dollar denominated assets unless they are prepared to let their currencies appreciate against the dollar. But the export-driven growth model of the Chinese and many other developing countries, based on undervalued exchange rates vis-à-vis the dollar, will in no way be given up in a deflationary world. To the extent that the surplus countries diversify away from dollars, they will depreciate

* This is a very complicated issue, originally proposed in a variety of forms by Lord Keynes and Robert Triffin, among others, and will be considered in future notes.

the dollar exchange rate, along with their trillions of dollar assets – a highly unlikely development in the short run.

The illogic of the key reserve currency country running persistent, massive current account deficits, which has repeatedly spawned credit bubbles and crises, is there for all to see and has been for years. The Europeans are rightfully angered, as they will likely suffer a worse recession than the US, despite their commitment to more disciplined monetary and fiscal policy. In the current environment, where crisis born from excess credit is fought with ever greater amounts of credit, discipline seems more of a handicap than a virtue – at least in the short run.

Therefore, the shape of life after the G-20 meeting has become clear. The countries that can, will sustain quantitative easing and unprecedented levels of fiscal stimulus, until the threat of debt deflation and mass unemployment recede. The great global reflation is now well underway. At the G-20 there was virtually no discussion of future monetary discipline, control of Government debt: GDP ratios, and the critical need for the reserve currency country to stop running balance of payment deficits. Therefore, asset price bubbles, banking crises and massive bailouts will likely become regular occurrences in the future. Much higher volatility is here to stay following below trend volatility while the credit bubble was inflating.

As the US economy recovers, expect the US current account deficit to explode upwards again, the Chinese and others to buy dollars and, as always, instantly return them to the US money markets. As Jacques Rueff famously remarked, *‘the childish game of marbles, where the winner returns his marbles to the loser after each round’* will continue. Artificially low interest rates will prevail, and the resumption – with a lag – of credit inflation, in both the surplus countries and the US, will resume. Interestingly, the crisis that was widely forecast – a loss of confidence

in the dollar and subsequent collapse, did not occur in the meltdown of 2008 – 2009. Rather, the meltdown was in the banking system and came about directly from the top-heavy US credit structure and a disastrous mismatching of assets and liabilities. If this crisis avoids a prolonged debt deflation, the existing international monetary framework will remain intact because no one really wants to change it, there are no good alternatives currently available and many beneficiaries.

When will the endpoint for this game arrive? In our view, it has many years to run, and at least another good bubble, maybe more. Just as it is difficult to predict how big an asset price bubble can get, or when it will pop, it is similarly difficult to predict the magnitude of US foreign debt deterioration before a final reckoning will occur. But this financial crisis has surely given us a peek at how bad things might get the next time.

While it is obviously premature to be speculating on the next bubble when we are still trying to abort a debt deflation, it is not difficult to see that another burst bubble will be far more dangerous as it will occur against a backdrop of waning confidence in national currencies. This will be particularly true of the dollar as the US public debt: GDP ratio* reaches levels that will seriously compromise US credit worthiness. The future capacity for banking sector bailouts will be reduced, and the desperation of export dependant nations to support a suspect Greenback will likely be softened as they implement policies to insulate themselves from a less dependable export market.

* See our recent commentary, “*The Coming US Fiscal Crisis*”, February 23, 2009

On a global scale, we are seeing massive fiscal deficits, monetary expansion and significantly augmented IMF liquidity resources to bail out developing countries.

Tougher financial regulations, as agreed at the recent G-20 meeting, may slow the development of the next bubble. But, a world awash in liquidity will not stop it. Only an abrupt removal of that liquidity would do so, but such a move would risk a huge spike in US and world interest rates, effectively scorching the green shoots of a delicate economic recovery which now seems to be evolving. The authorities will be navigating along a very fine line, with inflation on one side, and another descent into debt deflation on the other.

A Brief Look at China

As the principal counter-party to both the US current account and fiscal deficits, China is in a unique position and is currently undergoing a transformation to a fully developed economy that will be accelerated by the current financial crisis. The Chinese and Hong Kong stock markets are two bright spots for global investors, up 80% and 45% respectively from the lows. The former has crossed above its rising long-term moving average, almost always a sign that a new bull market has begun. The dramatic 70% sell-off in 2008 from the peak, not only cleansed speculation but, discounted a recession far worse than what appears to have occurred in China. There is evidence to suggest that the economy bottomed in the IV Q and growth is accelerating. One good barometer is the copper price (Chart 4 – *page 10*) which is looking quite frisky, driven in part by heavy Chinese buying in anticipation of much stronger industrial growth.

The key issue is dependence on exports, which accounted for 8.9% of GDP in 2007. Exports,

which have fallen by 50% since mid-2008, are not likely to recover much in the near future. But this weakness is being tempered by massive fiscal stimulus, and the authorities are pursuing

polices to support domestic

consumption. The

contribution of

consumption to GDP

growth surpassed that of

investment in 2008.

Consumption has been

supported by strong

income growth and the

savings rate remains high,

giving consumption

significant room to grow

further. Fixed investment

has also beaten analyst

expectations in the last

quarter. The real estate

market has also defied the

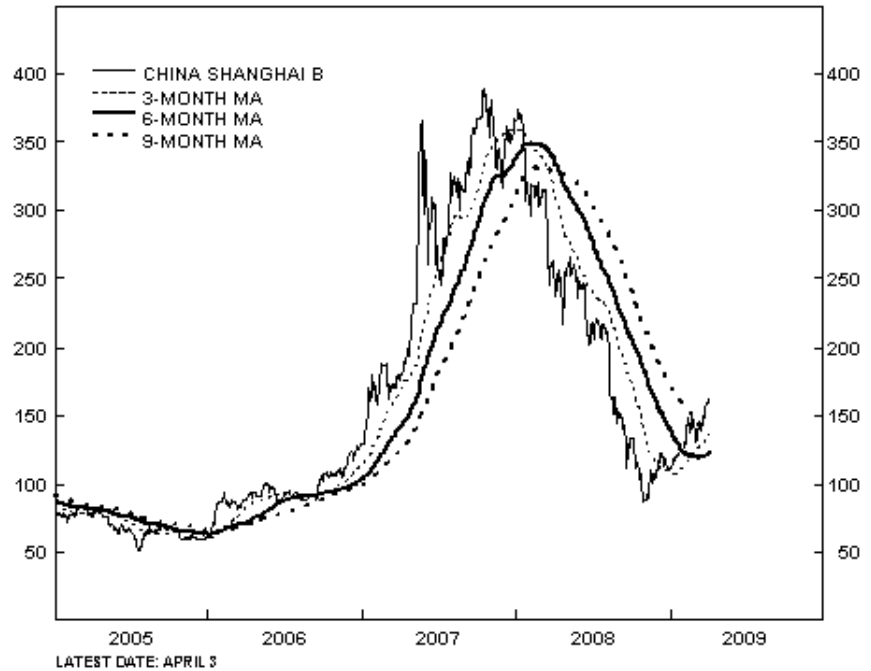
China bears, as transaction

volume remains high, and

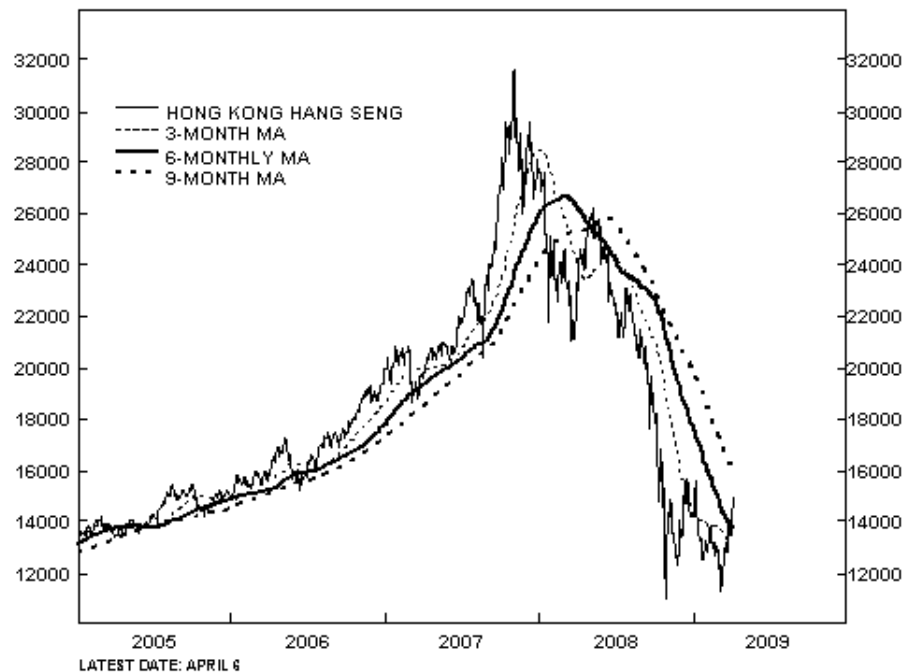
prices in major cities are

now rising.

CHINA SHANGHAI B INDEX - DAILY



HONG KONG HANG SENG INDEX - DAILY



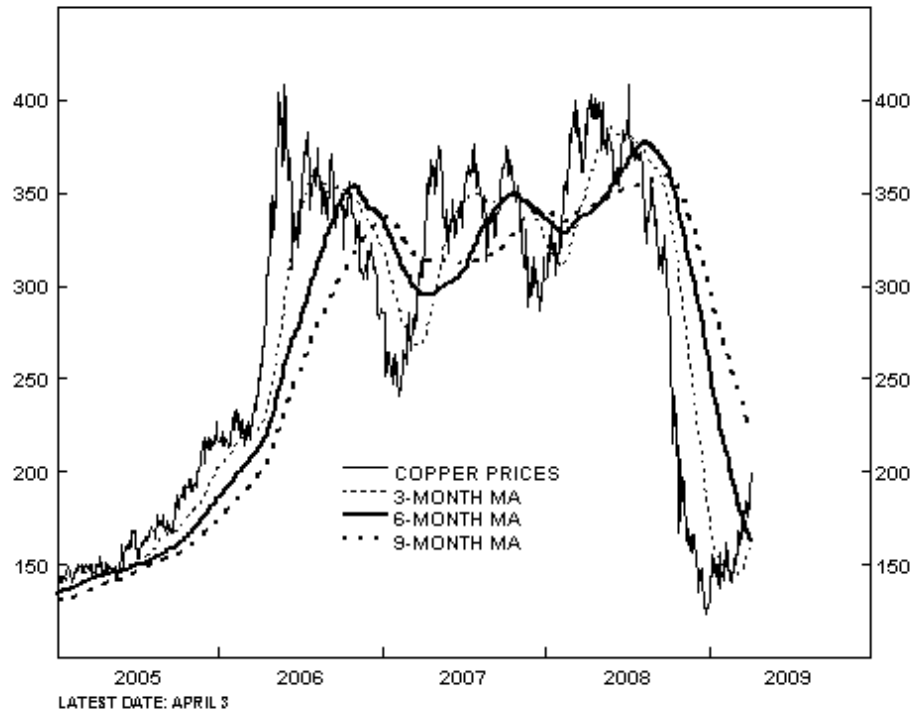
Given the authorities' capacity to increase the size of stimulus further if needed, it is likely that a soft landing is in store for China, if not already in place. GDP growth and unemployment may continue to surprise on the upside. The market is still 60% below peak values, and is trading on a P/E of 11x FY09E (based on JP

Morgan's growth forecast of 7.4%).

We continue to like China for the long run, but investors have to be prepared to live with sharp corrections in the short-term. For those who want generic exposure, there are a variety of Exchange Traded Funds (ETFs) with modest transaction and management fees.

Claymore/AlphaShares China Small Cap Index ETF (HAO) is one that we think investors should investigate.

CHART 4: COPPER PRICES - DAILY



Investment Thoughts

There is no change in our main investment views and, therefore, this will be brief.

The odds are high that US stocks have put in their lows; the excellent rally off the February bottom has taken the S&P back to the long-term falling trend line. A period of correction is natural, possibly a test of the lows (unlikely), followed by more upside. US markets will be in a

wide trading range for a very long time and it will take years before the old highs are exceeded. There is still a lot of stress out there and it is not going away anytime soon.

Other markets, like China, Hong Kong, and Canada look better. The trend of narrowing credit spreads will continue but high volatility must be expected as bankruptcies lag the cycle.

Commercial real estate is heading for a train wreck. Government-controlled rates will stay low.

Gold continues to struggle for the reasons mentioned in earlier commentaries – global deflation and excessive speculation. The flows into Gold ETFs has been massive as speculators discount a weaker dollar, and inflation, which is years away. Long-term, gold will prove to be a useful asset.

The lows in the pound sterling, Euro and Canadian dollar are in place, but it will be some time before large gains are made. The trade-weighted dollar is still 15% above its 2008 low and will weaken gradually.

Crude oil has also put in its low and higher prices will gradually emerge. OPEC spare capacity and high inventories will prevent major increases for some time. Canada, Norway, Columbia, and other net energy exporters will clearly be beneficiaries of this trend.

Tony Boeckh

April 10, 2009