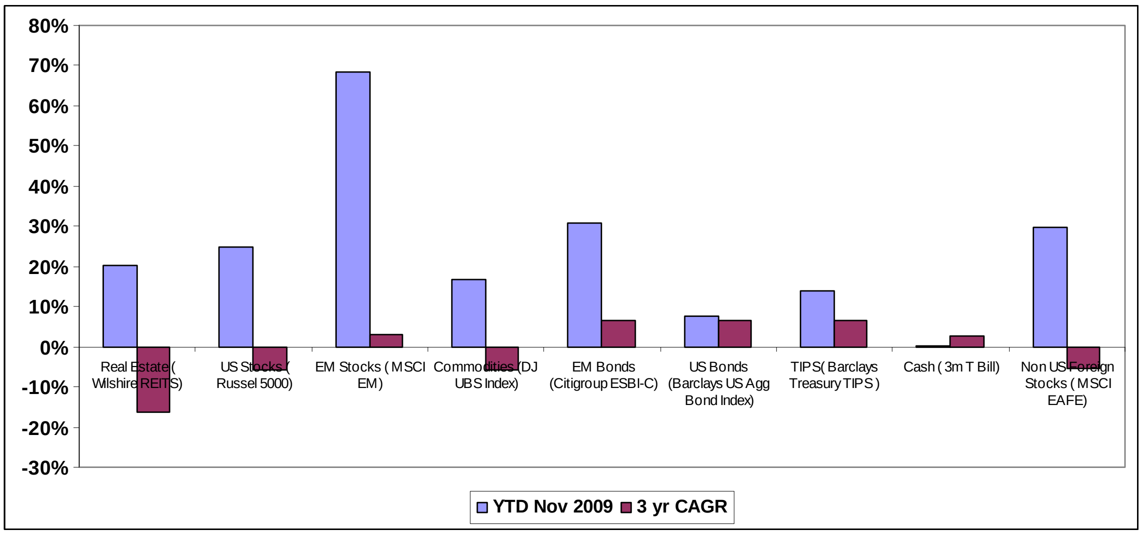
Title: Deflating Bubbles by Killing the Messenger

Country: GLOBAL Date: 11th December 2009 No of Pages: 6

As we near the end of one of the most euphoric year in the world of investments and returns, many investors are yet to recover from the shock of 2008. And this shock had made some of the investors numb enough to not invest in the Q1 of 2009. This numbness continues now in Q4 of 2009, as investors realize that many of the asset classes' world over are higher by 50-100% from its March lows. And few feel that the risk of investing at these levels is like facing Bret Lee delivery while playing cricket, without a helmet (head protection gear) on.

Chart I: Global Asset Class Returns



Source: malaysiafinance.blogspot.com. YTD 2009 returns are up to 30th November 2009

The worry that is holding back some of the investors is "What if it's an Asset Bubble "and the world goes back into the Boom-Bust cycle once again. As it did in 2008 during the sub prime crisis or the 2000 tech boom. Well, the apprehensions are not entirely unjustified, given the history of asset bubbles and the outcome of a bust of the same.

What are Asset Bubbles how do identify them and what is the policy response on the same? All these questions are the focal points of debate which can go on endlessly with academicians, economists, analysts, central bankers or policy makers' world over. The answer to these questions is not the objective of this note.

The most discussed cause of such Asset Bubbles, if any in recent times, is the massive monetary stimulus and the money printing undertaken by central banks or policy makers around the world, led by USA. Thus excess Liquidity allegedly is now the only culprit behind driving assets prices in the world away from their intrinsic or fundamental values.

For the time being though we can presume that Liquidity is the only cause of Asset Bubbles and the central banks and regulators will try and rein in the same.

But more important question is what drives the liquidity which in turn drives the asset prices higher? The simplest answer currently is the massive monetary stimulus and money printing undertaken by central banks of developed economies. But there is twist in the tale here.

One of the most relevant factor behind liquidity buildup which is often ignored as the cause behind the asset bubbles is the "Foreign Exchange Policy or the US Dollar pegs/semi pegs" adopted by many countries world wide.

A country can adopt one of the three models of foreign exchange policy vis a vis say the US Dollar. One is the free floating (flexible) currency system, where the domestic currency movements are completely market driven, such as USD-EUR At the other end is the US Dollar Peg, in other words the Fixed Exchange Rate system, where the domestic currency value vis a vis the US Dollar is fixed at a particular level, such as USD-Chinese Yuan. And the third one is the middle option of the first two. This system is known as the "Managed Float or the Dirty Peg", where the Central Banks actively manages the domestic currency volatility by buying and selling US Dollars in the open markets (intervention) as and when required.

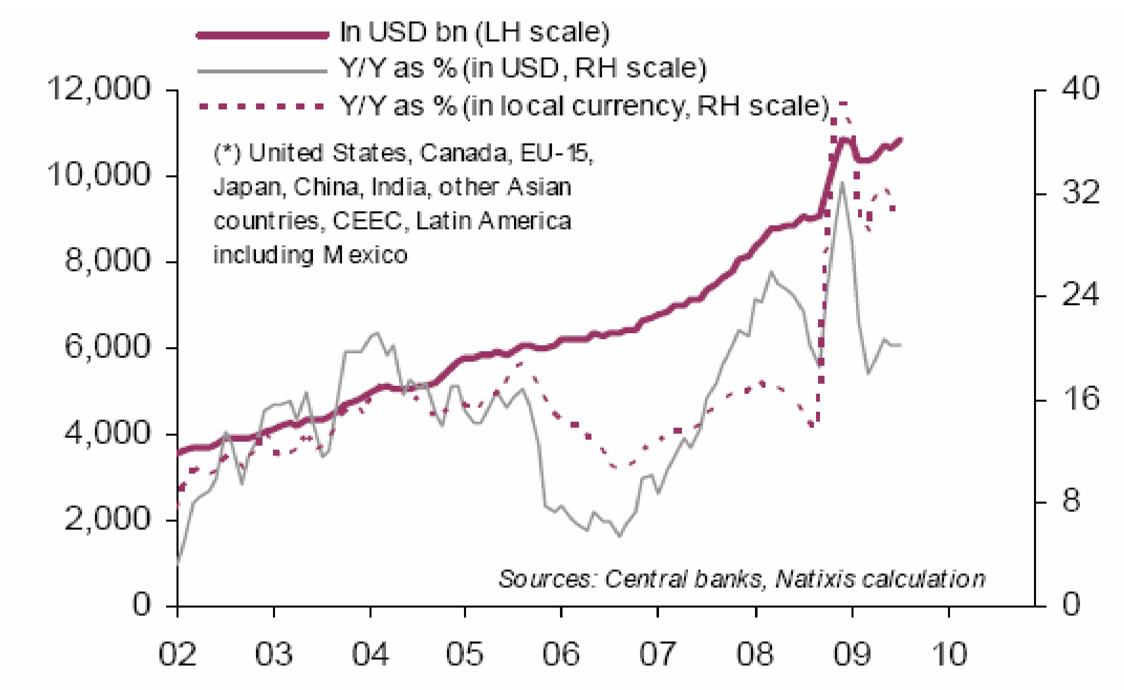
The US Dollar pegs and the Dirty pegs adopted by many central banks world over are more than often responsible for the liquidity infusion and the asset bubbles globally.

Many countries adopt the US Dollar pegs such as China (Yuan), the Gulf Countries (Saudi & UAE Riyals etc), and Hong Kong (Dollar). The apparent motive of adopting US Dollar pegs is to stabilize the currency at a pre fixed level thus making the external trade and investments more stable and predictable. Many central banks around the world adopt the Dirty peg too, even though it may not be expressly stated in the manifesto. The objective is to reduce volatility in the currency moves.

To defend these US Dollar pegs or to maintain value of its currency at the fixed rate, the domestic central bank often buys or sells (intervention) the excess/deficit of US Dollars in the domestic banking system. The central banks with dirty pegs also do the same as and when it necessary.

In recent times with US Dollar on a structural weakening trend, the domestic central banks on more occasions have been buying the excess US Dollars which may have come in the banking system in form of exports receipts, inward remittances, capital inflows etc. As the Central Bank buys US Dollars it infuses (sells) the domestic currency into the banking system thus increasing the liquidity with the local banks. This liquidity if not sterilized, lowers domestic interest rates, bank credit shoots up, raises inflation and boosts domestic asset prices.

Chart II : Global Monetary Base



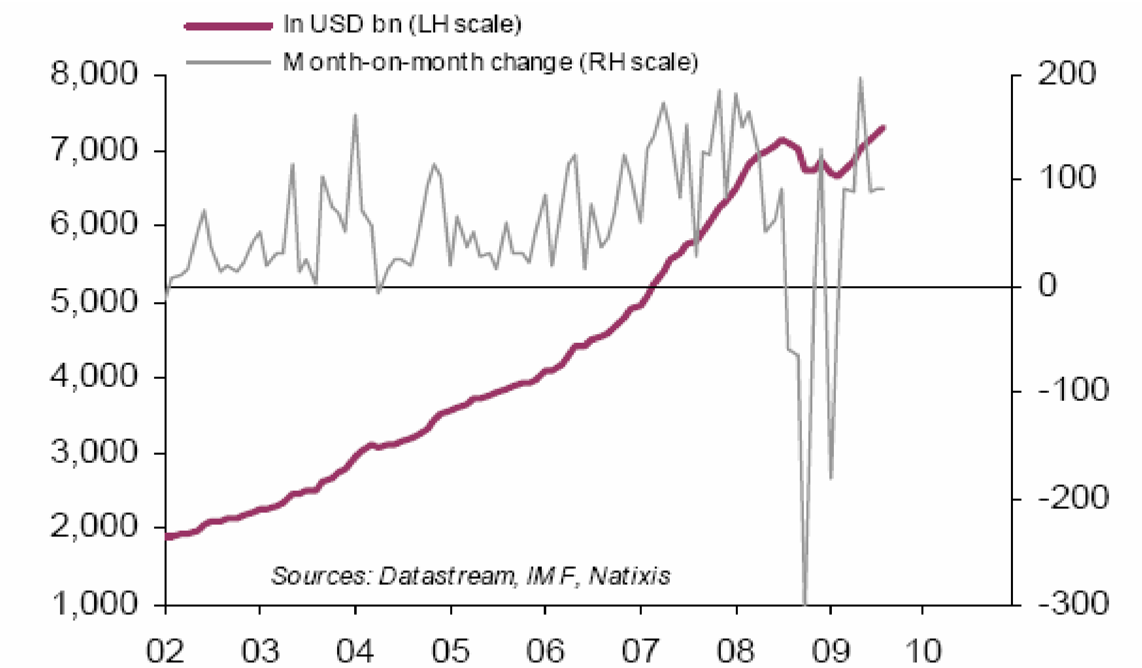
Source : Natixis Research

The global expansion of monetary base now stands at around USD 11 trn, almost 3 times of what it was in 2002. And the actual money supply will be much higher if the money multiplier effect is taken into account. The global monetary base is now at almost 22% of the capitalization of major global stock markets of around USD 49 trn.

The excess US Dollars thus bought by the central banks to maintain the fixed or the dirty peg ends up in increasing the official foreign exchange reserves of the country. The global reserves which were less than USD 2 trn in 2002, have multiplied almost four times since then to around USD 8 trn now. A rise of USD 6 trn in over 6 years.

Since the shock of the Asian Crisis, the Asian Central Banks have been building up there reserves as war chest in event of any fresh crisis, which might lead to run on their currencies (capital outflows). As the sub prime crisis led to a dislocation of the "export driven growth model", many Asian countries with the fixed exchange rate or dirty peg regimes, have been accumulating reserves (buying USD), to protect their domestic currency from appreciating and this hurting exports. China & Japan lead the pack of Asian countries with combined reserves of almost USD 3.2 trn. And China has a fixed exchange rate policy which is now the bane of all the problems for US and for the global imbalances.

Chart III: Global Official Foreign Exchange Reserves



Source : Natixis Research

These reserves in turn are invested by the central banks in safer investments such as US treasuries and more recently in Gold, which keeps the borrowing cost in US lower. This recycling process of global liquidity into US treasuries and the system of US Dollar peg often leads to the monetary policy (interest rates in general) of the country, which adopts the US Dollar peg, to be closely linked to the US monetary policy. Hong Kong Dollar is a US Dollar peg and the monetary policy of Hong Kong is closely linked to the US Dollar. (See Appendix I at end of this note). Usually the interest rates of both the countries will move in tandem.

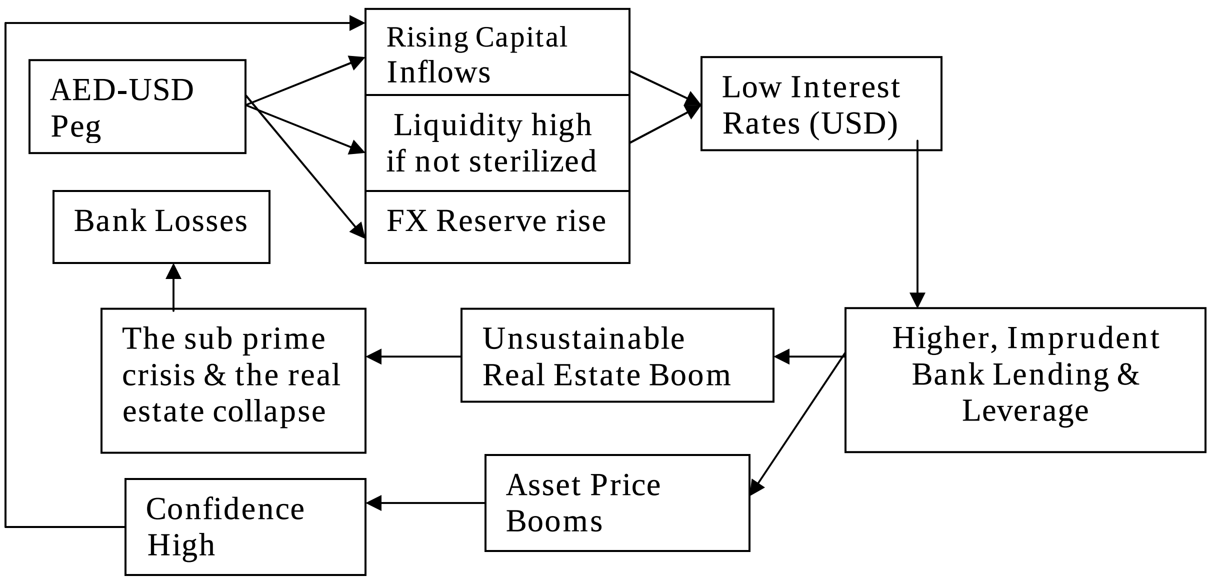
Dubai is a recent and fresher example. Most of us regarded the crash of real estate prices in Dubai by more than 50% from its peak as the central cause of the Dubai Debacle. But few paid attention to the reasons behind the surge in liquidity & the abnormal rise in Dubai's real estate prices a few years ago.

Dubai's Dirham (AED) is a US Dollar peg. The easy liquidity and accommodative policy adopted by US (almost zero interest rates) in last few years, through the US Dollar peg of AED got transmitted to the Dubai domestic markets. In turn it fuelled domestic liquidity driven credit & asset price bubbles, especially the real estate ones. As asset prices rose sharply, it attracted further liquidity (inflows) and investments leading to a self fulfilling cycle.

Dubai's ambition to become an International Financial Centre like New York & London was well marketed globally. Some glossy brochures on real estate projects and grandiose opening ceremony (Atlantis-USD 20 mn spent on fireworks) with some celebrity endorsements were good enough to attract USD investors, who were yield starved. Foreign Banks such as HSBC and RBS did the rest of the job by lending aggressively, allowing the investors to leverage at low interest rates thus fuelling a real estate boom in Dubai.

Dubai got trapped into a self made vicious cycle driven more by the US Dollar peg:

Chart IV: The Vicious Cycle



Source: Delta Global Partners Research

China is also a classic example of how US Dollar pegs play out. Higher reserves, higher money supply growth, higher bank lending and higher asset prices including real estate ones. And the FX reserves thus accumulated are recycled into the US treasuries holding the US interest rates lower. China holds almost USD 800 bn of US treasuries out of USD 2.2 trn of its foreign exchange reserves. And some of the top holders of the US treasuries are the US Dollar peg countries such as China & Oil exporting Gulf countries.

And it's not only China, but many of the Asian/Emerging markets Central banks intervene (buy USD) in the foreign exchange markets actively, specially to slow down the appreciation of its own currency in order to protect exports and reflate the economic growth dependent on it.

When the global liquidity is high, the US Dollar peg/dirty pegs currencies become a unilateral (appreciation) bet for global investors for the "Carry Trade", especially when USD, the funding currency is weakening structurally. The confidence of such trade comes from the fact that the US Dollar pegs/dirty pegs will be protected by Central Banks by buying USD, making the domestic currencies undervalued. Such Carry Trades focus more on the future central bank moves rather than economic fundamentals. The better relative growth prospect of Asia/Emerging markets countries also adds to the confidence of the Carry Traders. These carry trades often are behind the abnormal rise in risky assets such as Emerging Market Stocks and Commodities.

Central Banks world over are contemplating response to asset price bubbles and the exit strategies from the stimuli are being charted out including sucking out liquidity from the banking system. Are the central banks killing the messenger (liquidity) to deflate asset bubbles, rather than attacking the root cause?

Or do we continue to believe that its only liquidity that has caused all the harm and not the US Dollar pegs behind it. If the US Dollar pegs were not around, the currencies would have automatically adjusted to there to the new equilibrium based on external trade, balance of payments and other macro economic factors. In such an event, the messenger would have never come to the central banks doors and not got killed. And the World would have been a much better place for economists and fund managers.

Devendra Nevgi
deven@dgp.co.in
Tel : + 91 9867 277 977

Delta Global Partners
Founder & Principal Partner

Appendix I : The HK Dollar Peg , Liquidity & Real Estate Prices

*The aggregate balance measures the level of interbank liquidity. Source: CEIC, BofA Merrill Lynch calculations.

Source : BofA ML Research

Title: Deflating Bubbles by Killing the Messenger

Country: GLOBAL Date: 11th December 2009 No of Pages: 6

IMPORTANT DISCLAIMER:

The note and the suggestions in it are for information purposes only. Delta Global Partners do not take any responsibility of the losses that may arise out of actions taken based on the note. The figures and charts may not be authenticated by any authority. Please make an independent review before taking any decision. Delta Global Partners does not intend to act as a portfolio manager or investment advisor registered with SEBI or under any other law. The author of the note may or may not have exposure to the strategies suggested, if any.

NOTES