FVCM

Global Market Notes

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EMERGING MARKET(S) WEAKNESS

U.S. equities are expected to outperform global benchmarks like the MSCI World Index in the quarters ahead because of global inflation differentials and the effects that flow from different monetary policies. The blue line in the chart above is a relative strength line—when it rises, the MSCI is outperforming the S&P 500 (SPX), and when it falls the SPX is outperforming. As can be seen, the SPX has been outperforming since about mid-2010 from a short-run perspective, and since mid-2008 from an intermediate term perspective. The SPX has outperformed the MCI World Index by 106% over the past 20 years, rising 287%, versus "only" 181% for the MSCI World Index. With inflation low in the U.S., but high and rising in many of the countries now running trade surpluses, ongoing outperformance the SPX looks likely.

CHINA IS THE KEY TO THE PUZZLE

As we have long anticipated, rising inflation is the price the Chinese are paying for their currency and trade policies. Beijing today reported that the January consumer price index (CPI) for China was up 4.9%, year over year, which was slightly better than feared but still a lingering problem. The volatile food sector was up 10.3%, year-to-year, due largely to rising commodity prices. In contrast to the CPI, the January increase in producer prices of 6.6% was above expectations and another indication that inflationary pressures are growing at untenable levels. Also, price pressure that originally was seen in more sensitive commodity prices is now clearly effecting more “sticky” components of the economy like wage rates.

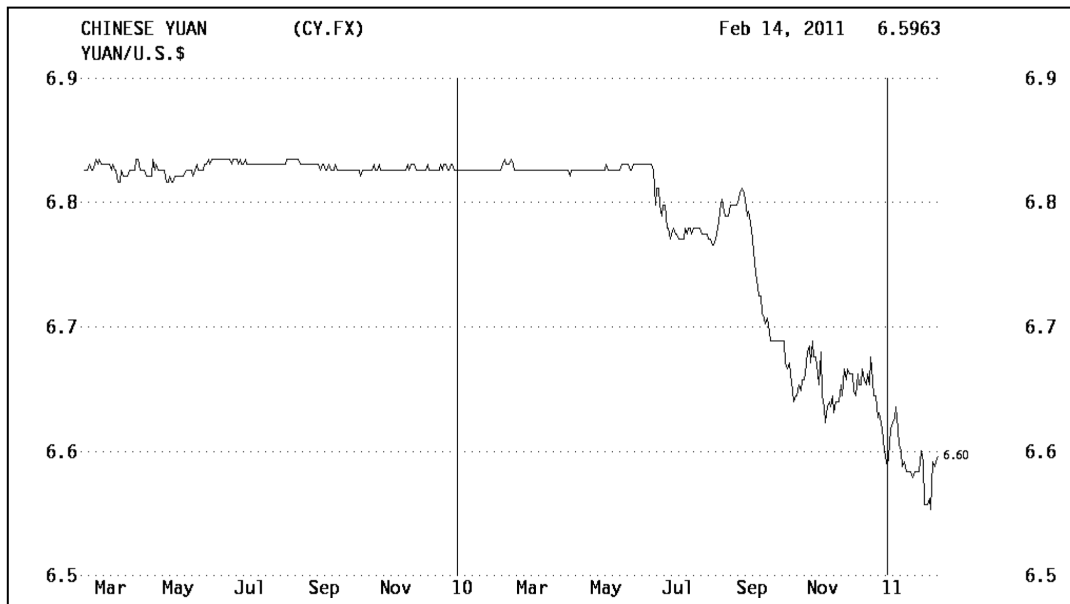
The first order cause for China’s inflation problem is rapid growth in the domestic money supply. The broad money supply (M2) recently has been growing at a pace approaching 20% and during the financial crisis was growing at a pace of about 30%. As Milton Friedman famously said, inflation is always and everywhere a monetary phenomenon. So you may ask ‘why would the People’s Bank of China allow the money supply to grow so rapidly.’ The central reason for the fast money growth and inflation is China’s policy of pegging its currency to the dollar at a level that has been estimated to be perhaps 40% or more below the purchasing power parity (PPP) exchange rate, which is the “fair” rate at which the two currencies would be able to buy the same basket of goods.

It is impossible to control both the foreign exchange rate of a currency and the domestic monetary policy—a central bank has the choice of one or the other. Period. Full Stop. Some nations, like the former East Germany or Venezuela today try to dictate an “official” exchange rate that may be used for certain controllable government transactions, but such exchange rates are useless for foreign transactions in the marketplace because no one would willingly exchange goods or convertible currencies for a fixed currency at an inflated official government exchange rate. Such official exchange rates are a fantasy that exists only in a closed national system. In contrast, the Chinese are able to maintain a particular exchange rate (a “peg”) vis-à-vis the dollar, but it requires the constant intervention in the marketplace by the central bank. The Chinese central bank must issue Yuan (i.e., create money) to buy dollars in order to maintain the peg. This means that, unlike the ECB or the Fed, they cannot use monetary policy to control domestic spending and demand or interest rates in the marketplace. Because of the Yuan peg to the dollar, if the Fed eases, the People’s bank must ease. Unfortunately for the Chinese, the Fed has an easy policy because of the slack economic conditions and low inflation in the U.S., whereas the Chinese economy is booming and inflation is rising. The Chinese want tighter monetary policy but have trouble because of the peg. They can’t do both and, hence, have resorted to criticizing the Fed because the Fed is not providing the policy their domestic economy requires.

The currency peg means that adjustments that ordinarily occur in the currency markets are going to be made in the domestic Chinese market. Instead of having a currency that adjusts upward towards PPP, the Chinese will get inflation that drives down the purchasing power of their currency. Because the Chinese currency is so far below its fair value based on purchasing power, Chinese goods and services are cheap in the international markets when priced in dollars and the Chinese are able to consistently maintain large trade surpluses with the U.S. However, the trade surpluses mean that the Chinese earn dollars. As businesses try to convert those dollars back into Yuan, there is downward pressure on the dollar and upward pressure on the Yuan. In order to maintain the peg the Chinese central bank has to buy the dollars and issue Yuan, thereby accumulating large dollar reserves and causing the domestic money supply to expand. When one country’s exchange rate is undervalued based on purchasing power and is running a persistent trade surplus, the adjustment mechanism is normally that the currency will appreciate and the trade surplus’ would thus narrow or disappear. However, by maintaining the peg, the Chinese have removed that adjustment factor. This doesn’t mean there won’t be an adjustment; There will! It means the adjustment will now take place in the local markets as the cheap Yuan means fast money supply growth and inflation. The adjustment now becomes a consistent decrease in the purchasing power of the Yuan through inflation until it

eventually reaches purchasing power parity with the dollar (i.e., if Yuan inflation is higher than dollar inflation, the Yuan loses relative purchasing power).

The Chinese realize that they cannot maintain the dollar peg and fight inflation at the same time, which is why they have been allowing the Yuan to appreciate slowly since mid-2010 (see Chart 2 below). The Peoples Bank of China has been raising bank reserve requirements and official interest rates in parallel with the gradual appreciation of the Yuan. By allowing the peg to weaken, they essentially have given themselves back some control of their domestic monetary policy. Looking ahead, there are likely to be several more interest rate hikes and increases in bank reserve requirements and the Yuan could reach nearly 6 to the dollar by the end of 2011.



The Chinese are not alone with an inflation problem. Inflation rates have been rising in many Asian countries that compete with the Chinese because they have run loose monetary policies so as to depress their currencies and be able to better compete with the Chinese in the export markets. In this way, the Fed has effectively become the central banker for many emerging market economies. The Chinese follow the Fed and the others follow the Chinese. The Brazilians have also been very loud and vocal critics of the Fed because of the inflation problem they are having for similar reasons. But of course all of these countries are free to fight inflation by tightening their domestic money supply and allowing their currencies to appreciate against the dollar. But, of course, if they do that their exports and economic growth will slow. This they don't want. Unfortunately for them, the laws of economics cannot be avoided for long.

The U.S. business cycle is at a very favorable stage for the equity markets. Firstly, most forecasts call for the US to experience real growth of between 2.5% and 3.5% in 2011. We think those figures will prove to be too low. We're looking for 4% growth. To begin with, the impact of the Fed's monetary policy is probably being underestimated. The new liquidity being provided is having a first order effect of driving stock prices higher. And as we saw in 2008, changes in household net worth have a tremendous impact on spending. With stock prices rising, spending should follow. And, indeed, retail sales have been increased at a good pace. Housing and construction remains weak, but on balance the signs are pointing up because Americans are looking at their portfolios and are feeling wealthier again.

The Obama/Republican tax agreement has quite positive implications. The top marginal tax rate on ordinary income ("Bush" tax rates) will remain at 35% rather than rise to 39.6%, and the 15% tax

rates on capital gains and dividends will remain. Continuance of these lower rates will remove uncertainty and enhance incentives for businesses to expand and hire new employees. Furthermore, a prominent feature of the tax deal allows businesses to immediately expense 100% of qualifying 2011 capital expenditures. This will boost corporate cash flows by an estimated $150 billion in 2011, or roughly 8%. These incentives will likely result in more capital spending and faster growth than currently expected.

There are early signs that the labor markets are beginning to positively react to rising demand and the recovery will become "self-sustaining." Initial claims for unemployment payments from the government have been trending downward. The average for the four weeks ended February 5, 2011 was 415,500, which is back down to the level seen in mid-2008. And, while the economy added an average of only 94,000 jobs per month in 2010, this pace is expected to accelerate. Indeed, the 94,000 figure comes from the "establishment survey" of roughly 400,000 businesses. It has been argued that the establishment survey underestimates the number of jobs created early in an economic upturn because it does not count new businesses. As the labor markets recover, national income rises and helps fuel ongoing growth.

U.S. equities are expected to continue to outperform the MSCI Index in the quarters ahead. **S**tocks in many of the "Emerging Markets" have been underperforming the S&P 500 since at least mid-2010 at about the time the Chinese started allowing the Yuan to appreciate. Because of the developing inflation problem, those nations face the ugly reality of having to tighten monetary policy. As we have seen many times in the past, equities perform poorly in high inflation environments because inflation depresses valuations. At the same time, the tightening of monetary policy will have downward pressure on corporate earnings growth. In contrast, the year-over-year increase in U.S. consumer prices was only 1.4% and the "core" CPI rose only 0.8% year-over-year. And, as just discussed, the Fed is determined to maintain an easy monetary policy. The positive benefits are likely to be faster economic and corporate earnings growth, as well as higher stock prices.

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