



# Global markets, watch out!

There are a number of reasons why the current optimism in the financial markets may be a chimera. **Matein Khalid** urges caution.

**T**he financial sun used to rise in Singapore and set in Manhattan, even five years ago. Yet, the inexorable rise of BRIC means that the sun now rises in Shanghai and sets in Rio de Janeiro, even as its glare illuminates Moscow and Mumbai. Shanghai led the world markets down when the grizzlies ran amok in October 2007 and led the world when the bulls seized control in March 2009.

The Chinese Politburo's decision to stimulate its economy with US\$1.1 trillion in bank loans, a feat only possible in the Middle Kingdom's command economy, triggered the current rally in global equities. The euphoria only deepened when the American central bank slashed interest rates to zero and began to buy a trillion dollars of toxic mortgage bonds in March 2009. Naturally, the Chinese Politburo's fiscal largesse ended up in the Shanghai property and real estate bubbles.

The Chinese government has, in essence, created the illusion of white hot nine per cent GDP growth, even as world trade contracted for the first time since Deng Xiaoping repudiated Chairman Mao's ideology and declared that to be rich is glorious. Yet, China's promiscuous 40 per cent bank credit growth rate will trigger an inflation nightmare, exactly as happened in the GCC in 2006-2008. The People's Bank of China will be forced to raise interest rates

and boost bank reserves as early as next February. Chinese money supply growth has gone ballistic and the 20 per cent fall in the Shanghai stock index in August has now turned into something a lot more sinister. It is no coincidence that US\$2-3 billion IPOs in the Hong Kong IPO markets, such as Metallurgical Corp of China priced at an unjustified 22 times earnings, are snapped up by eager investors in Hong Kong. A rally driven by government stimulus and speculative margin trading is living on borrowed time. Watch out.

Asian equities have soared more than 60 per cent in 2009 on the Panglossian view that the Chinese stimulus and Federal Reserve monetary largesse will create the best of all possible worlds for the US consumer in 2010. Nonsense. In 1998, Asian economies snapped back from the 1998 currency/banking meltdown because the US consumer was cash rich and tech mania on Silicon-Valley-triggered soaring asset values. Asia exported its way out of a savage recession with the US consumer as its macroeconomic locomotive. Yet, the US consumer, one-fifth of the global GDP, could well take five years to recover from an epic destruction in net worth in the property crash, mounting job losses, anemic wage growth, epic debt burdens and the

new mania for thrift (deleveraging in the icy jargon of Wall Street economists).

The American consumer economy is worth US\$10 trillion, four times more than the combined consumer economies of India and China. Can the emerging markets, with their dominant model of export-led developments, decouple from a multi-year US consumer retrenchment? No way. Can China and India replace the US as the largest, most profligate consumer in human history in the next decade? No way. Yet, why should Asia (excluding Japan) trade at a significant premium to western equities and its own valuation range if its GDP growth is largely hostage to the US consumer? Even domestic consumption-oriented Asian economies like Indonesia and India are vulnerable to the mood swings of global investors (capital inflows in the jargon of the dismal science) into their local stock exchanges. Watch out.

The collapse of the dollar reflects Wall Street's deep discontent with Obamanomics and the penchant to raise taxes, regulate banks, raise spending and generate trillion-dollar Uncle Sam budget deficits. Even the Democratic-Party-dominated Congress estimates that the 2010 budget deficit will be a shocking US\$1.6 trillion. This will mean that Washington's financing needs will surge at the same time as Asian central banks,



its traditional creditors, accumulate lower reserves from exports.

US debt is hardly attractive to foreign investors at a time when the Bernanke Fed has launched history's greatest money printing spree, known in polite company as quantitative easing. It is no coincidence that more than half of all Treasury bills, notes and bonds outstanding are held by foreign investors, primarily the central banks of Japan and China. Yet, Chinese and Japanese inflows into the US Treasury market in the past year have plunged by US\$200 billion a quarter. The dollar rose when real interest rates were strong (Reagan in the early 1980s) or Silicon Valley's Internet IPOs lured foreign money, as under Clinton in the late 1990s. Yet, American stocks and bonds will no longer enjoy a performance advantage in the decade ahead. Watch out.

The gold market's recent breakout above US\$1000 an ounce, an event I had predicted in late 2008 when gold traded at US\$800, disconcerts me. Why should gold soar in a world where geopolitical risks in the Middle East are muted (Obama's rapprochement with America's enemies and troop withdrawals from Iraq) and banking risks have been contained (the reason the Ted spread is only 20 basis points and the shares of Barclays/Citigroup/Bank of America have quadrupled in the past six months)? Moreover, it is obvious that inflation risks are meaningless (the American CPI fell in July and global industrial spare capacity is at its highest since the 1980s recession) and physical demand (jewellery demand) is at a six-year low. Dubai gold exports have plummeted. The fact that

Indian brides are reluctant to buy 10-tola bars at stratospheric current prices means fundamentals no longer boast the yellow metals. Yet, despite no banking, geopolitical or inflation risks and lousy fundamentals, gold has finally soared above US\$1000 an ounce. Why? A global loss of confidence against the US dollar, whose US Dollar Index has fallen below 78 from 90 in March.

In essence, the London G-20 conclave determination to print money, the real risks of beggar thy neighbour competitive devaluations, the Chinese reserve buying of bullion and the reluctance of international investors to finance Obama's trillion-dollar deficits have all combined to turbo-charge the bull market in gold. The financial markets are now convinced that the world's most powerful central bank will do its best to reflate debt-burdened economies with easy money at zero interest rates. Ben Bernanke and Barack Obama risk a global panic-run against the dollar and US\$1200 (or even higher) gold. Watch out.

### Argument for caution

The clear message from the conclave of central bankers at the recent Federal Reserve's Jackson Hole monetary conference and the London G-20 meetings of finance ministers was that cash rates in dollars, sterling, Swiss francs and euro will remain near zero for an extended period. After all, the three-month Treasury bill yield is a mere 12 basis points and the three month Eurodollar rate is only 32 basis points, meaning that the money markets have concluded that the international banking credit risk (whose proxy is the Treasury bill/Eurodollar or Ted spread) is the lowest in the generation at only 20 basis points. This is an absolutely ridiculous notion in a world where the International Monetary Fund estimates US\$2 trillion in bank asset write-offs, Wall Street money centre bank colossi such as Citigroup trade below US\$5 a share and European Central Bank inflation hawks such as Bundesbank head Axel Weber are forced to act as de facto lenders of the last resort to German banks trapped in the credit/mortgage Armageddon.

It is also significant that the entire US Treasury bill, note and bond-yield curve has moved lower in the past three months. The yield on the bellwether Treasury note was

almost four per cent in July. It has now fallen to a mere 3.40. The conclusion is obvious. Unlike the full throttle bull run in the global equity market, the bond market does not believe that the global economic recovery will be anywhere near as robust as investor risk appetites, Lord Keynes's proverbial animal spirits of capitalism suggest. This divergence between equities and bonds is a compelling argument for caution. Watch out.

The storm clouds of international politics can well derail the bull run in the financial markets. The election of President Obama promised the end of the confrontation ethos of the Bush era. Yet, war and terror continue unabated in Iraq and Afghanistan, and no Palestinian-Israeli peace settlement is in sight. In fact, the withdrawal of US troops could well trigger another sectarian civil war in Baghdad or even an Iraqi-Syria conflict. An Al-Qaeda suicide bomber almost assassinated a senior prince of the House of Saud in his own palace. Iran allegedly backs an insurgency in Yemen even while Al-Qaeda uses terrorist attacks against Saudi Arabia, the central bank of black gold and Washington's closet ally in the Middle East. A renewed war between Israel and a resurgent Hezbollah is not at all unthinkable. The Uighur rebellion in China's Sinkiang province could well threaten the economic stability of the Middle Kingdom. The west threatens to tighten sanctions against Iran to compel the Khomeini/Ahmedinijad regime to stop its nuclear programme. Massive vote rigging compromised the NATO mission in Afghanistan and its human symbol President Hamid Karzai.

The financial crisis has wrecked havoc on the lives of hundreds of millions of human beings and has devastated economies and property markets that might not recover for the next generation. It has eroded the legitimacy of dozens of autocratic, as well as democratic, governments all over the world. The endgame of the 1930s Great Depression was Hitler, Mussolini and World War II. The lights may well go out in diplomatic chancelleries in the dark alleys of the planet, a grim scenario not priced into current prices. Watch out.

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