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REMEMBERING THE FUTURE

Vol. 1, Issue 3, August 2009

Sleepwalking on Thin Ice: Rallies, Currencies, and Risk Assessment

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Introduction

Most analysts these days are trying to convince themselves and the rest of us that the recession is over (or nearing its end) and that things will return to normal soon. The justification they offer is the stock market rally, the profitability/earnings reported by a good number of corporations, the drop in job losses, and the higher recorded confidence levels. The obvious question of course is: Who financed all that and what means were used to finance that "turnaround"?

We do not need to look far for the entity: The federal government in conjunction with the central bank has been taking extraordinary measures to uplift the fortunes of the economy. My question is: Is that lasting medicine? Does it cure the cause or does it merely treat the symptoms? Is such treatment sustainable?

It would be very hard to believe that the biggest bust of the last seventy years in different markets (derivatives, stocks, real estate, etc.) could simply be cured by throwing money at those who planted the seeds of destruction. And even if that were to be part of the proper solution, how often and for how long could that partnership - between the federal government and the Fed - circulate hundreds of billions of dollars in dozens of projects and extend trillions of dollars in credit guarantees? If the fundamental problems/causes are not being addressed, and if both micro (such as earnings and productivity) and macro (such as growth, and debt) issues are not being resolved, then the rallies we see could be perceived as sleepwalking on thin ice a.k.a. suckers' rally.

If the recovery is based primarily on that partnership, then we should be expecting the second phase of the crisis to show up with a bang. Thus, the theme of this month's newsletter: The risk of a currency crisis that will shake the foundations of the global economy, in a similar manner as the de-linking of the dollar from gold in 1971, shook the world economy then. Please note that I do not say that such a currency crisis has to happen. I am simply stating the facts that unless we cure the causes, then it is unavoidable to fall not just into a double dip recession, but even worse, to experience in the foreseeable future a crisis where trust in fiat money will be questioned in the best-case scenario, and abandoned in the worst-case scenario.

From Recession to Recession: De-Coupling and the Emerging Markets

In last month's newsletter, a suggestion was made that in the new economic model that has been in the works, emerging markets should be more promising than developed-countries' markets. Moreover, we contemplated on the assumption that the debt/bond markets will soon be seeing higher levels of non-US denominated traded securities. The empirical facts of the last few months also point to the reality that emerging markets have been performing better than US and EU markets. Thus, in terms of asset allocation, we would like to reiterate our position that a greater percentage of individual and institutional portfolios should be allocated towards emerging markets. Markets in Brazil, China, Russia, India, Vietnam, Malaysia and other countries, hold significant promises both in terms of resources, and in terms of a developing production, consumption, and credit dynamic. They are building the necessary infrastructures[1] that could sustain their development, and thus reaching the critical and necessary mass to be lifted higher.

The graphs below portray some of the above facts. We would encourage you to call the office in order to discuss possible options and opportunities regarding allocations in emerging markets.

Brazil's ETF (blue) vs. S&P 500 (Green)

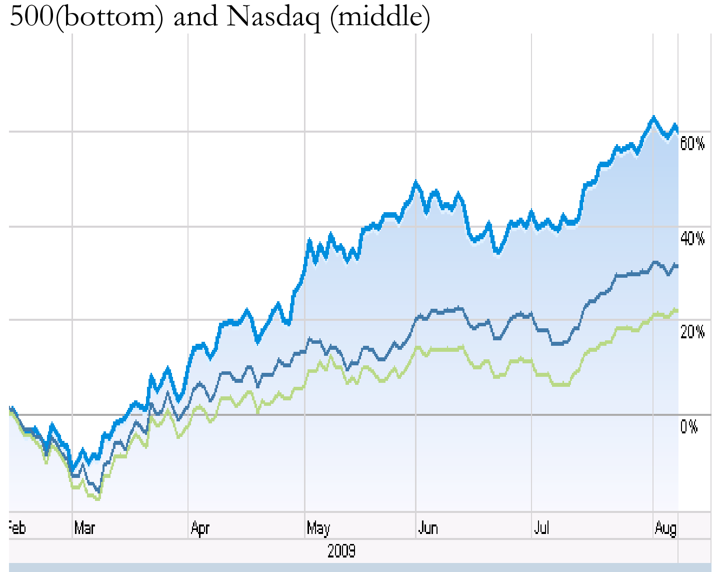
Source: Author's charting

[1] For example China this year alone is spending over $50 billion in high-speed rail systems that will expedite traveling and enhance mobility, both of which are necessary ingredients of higher productivity which is the key to growth and profitability.

BRICs (Brazil, Russia, India, China) ETF vs S&P 500 (Green)

Source: Author's charting

Emerging Markets ETF (top) vs. S&P 500(bottom) and Nasdaq (middle)



Source: Author's charting

Assuming that the current market rally in the developed markets (which still have hundreds of billions of dollars in worthless derivatives on their books) is unsustainable, and taking also into account the facts of de-leveraging on behalf of both consumers and producers, the implosion in the commercial real estate market that could start this fall and which could have repercussions to the tune of over $150 billion, as well as the possibility of having the Social Security cash account turn negative this year or next[2], then we could conclude that a double-dip recession is a real and viable possibility. The Japanese have been experiencing exactly that for the last twenty years. Given the above, we could contemplate two things: First, the enhancement of the de-coupling hypothesis and the sought-after refuges such as hard assets (see previous two issues.) Second, confidence in the dollar will be shaken, with the result that the dollar will be devalued against metals and other currencies, without losing its international reserve currency status.

Let's examine briefly some of the consequences of the above possibility. First of all, it would cure some of the global imbalances. Specifically, the US trade and current account deficits will shrink. Their mirror images i.e. the surpluses in China, Japan and elsewhere will also shrink, which is part of the much-needed prescribed medication. In addition, our net financial position will improve, since we will be paying back with inflated fiat money. Even more importantly, the currencies of our net creditors will strengthen (part of the cure prescribed for the global imbalances), which will enhance their consumption capabilities and patterns.

The net creditors of the US provided the necessary financing for a spending-spree, by buying toxic assets. Now, it's time to turn inwards, and use those surpluses for domestic consumption, that will free them from relying on the US as the buyer of last resort for their products, as well as the provider of toxic paper-assets. The new economic model that we wrote about last month, involves higher consumption levels for emerging markets (but also for some developed markets such as of Japan and Germany whose consumption level is much lower than that of the US), lower significance of the dollar over time, and global institutions whose role will be enhanced. The first aspect of that model, will also assist US-exports (thus recovering a balance and achieving a convergence among nations in terms of their export-led growth dynamics), while the second will contribute in developing consumption and credit markets for the those emerging countries. The third will be the natural consequence of a much higher integrated world whose production, distribution, and consumption patterns will be coordinated by currency arrangements that will portray the flexible but stable financial conditions that prevailed after Bretton Woods.

Conclusion

As the above discussion portrays, in the next several months we might be experiencing the second phase of the crisis, which will show its face potentially as a currency crisis – prelude to the new model - where coordinated global finance will rely less and less on US-denominated assets. There are options available to hedge against the possibility of such currency crisis. Feel free to call the office to discuss such options suited to your portfolio. In the meantime, enjoy the ride!

[2] According to the Trustees' Report in 2002, the cash account was projected to have a surplus of $119 billion this year. However, according to the latest report – based on 2008 data – that surplus was estimated to shrink to $19 billion due to higher unemployment rate. If we take into account that the unemployment rate is worse than projected, then even that minimal surplus could disappear, which would force the administrators to start liquidating assets i.e. government bonds. That in turn, will force the Treasury to issue more debt. From a market psychology perspective, that could be very demoralizing to the debt (read international) holders, and could be part of a perfect storm for the currency markets.