

A world awash with bubbles!

It feels as if the world markets are moving from one bubble to another. Some of the most recent speculative bubbles that come to mind are – the dot.com bust in early 2000, Japan in the 90's, the real estate bubble and last but not least, the aftermath of the credit/sub-prime (housing) bubble that we are living through today.

Bubbles typically start slowly and build momentum over an extended period of time. It generally accelerates at its peak as new investors look to make a cheap buck, yet get in almost at the end. There is a feeling of euphoria as everybody feels like a genius, and then it comes crashing down. Prices fall abruptly, and then enter into a mild recovery. After the recovery there is usually a protracted period of **several years** when prices slowly grind lower and market participants leave the markets.

Bubbles also seem to be synonymous with loose credit policies and/or cheap financing. Whenever credit is easy, bubbles pop invariably pop up in various markets. They are no longer contained to a single region or market, rather exposing themselves to the entire global economy. At the peak of a bubble, misleading financial statements and sometimes even fraud occurs. (Note – the amount of write downs and capital raising investment banks have done so far). Bursting bubbles are often followed by recessions.

The bigger question is what is next bubble? We identify three potential bubbles in the making:

1. **The currency bubble** – The Euro, British Pound, Aussie, Kiwi, & the Loonie (Canada) have all appreciated significantly vis a vis the US \$ since 2001. As of the end of August 2008, the trade weighted US\$ is down 40% from its peak in 2001. Has the US\$ (greenback) depreciated too far, is it bubblicious?
2. **The US Government yield bubble** – Is the second bubble a sharp sell off in the US Government bonds, with the US 10yr note trading close to its historical low? As an investor, would you finance the US Government at these levels?
3. **The commodity bubble** – Will prices of oil, iron-ore, copper, zinc, food, milk continue to rise at the current pace? Or is it a bubble in the making?

Let's address each one of these bubbles:

The currency bubble

- The US has improved its standard of living over the past 20 years by not only being innovative (with respect to the creation of products), but also through the use of excess leverage (via cheap financing to consume goods and services). The former is perfectly healthy as innovation and improvement in productivity naturally increases standards of living and improves people's lives. But the later (leverage/borrowing), only improves one's standard of living in the short run. As we have seen over the course of the past year, this can be construed as dangerous game.
- When the music stops, so does the era of binge borrowing. There is generally a fall in the standard of living and it invariably ends in tears. We are not sure how much of the recent new paradigm and global growth was driven by improvement in productivity and how much through leverage. One thing is clear, that a combination of both caused the recent economic boom.
- In the last two months, the trade weighted US\$ has appreciated nearly 10% This surge is not because the US economy is growing rapidly, rather that the other economies, such as Europe, UK, Canada, Australia and NZ are all facing the grim prospects of a credit binge that is rapidly unwinding.

- The US was quick/forced to admit to its problems early, hence the Fed stepping in to cut interest rates and take measures to ensure that the economy did not fall into a deep recession. Moral hazard or not, the Fed did what it had to do to bail out the economy. The rest of the countries were in denial, claiming that it was a US centric problem (remember decoupling?). Add to this equation the slowdown in emerging market economies (mainly India and China) and in commodity consumption. Quickly thereafter, the rest of the global economies joined the party. The result: a fall in currencies of the major economies, and without any alternative, the US\$ began to appreciate. Hence why Kapstream is **bullish the US\$**.

The US Government yield bubble

- The Fed could partially be blamed for the current problem that the world economy is facing. Greenspan and company took the Fed Funds rate to 1%, pumped liquidity into the market, and provided cheap credit to anyone and everyone. While this fixed the dot.com bubble, it created the credit bubble.
- This means that the US is just postponing, yet again, its problems and not taking its medications to solve the long term sickness of binging on excess credit.
- In the process of bailing out the economy, the US has run up a large budget deficit, played the role of the world's policeman (wars in Iraq, Afghanistan), and has been forced to bail out large financial institutions (Bear Stearns, Freddie Mac, Fannie Mae).
- The run up in the deficit coupled with India and China joining the world economy has driven up demand for goods and services resulting in an increase in global inflation.
- The world's central bankers are now stuck between a rock and a hard place: keep short term rates high to fight inflation or reduce rates to encourage economic growth thereby stoking higher inflation in the future.
- One thing is clear, the Fed is eager to normalise rates as soon as there is a hint of a stable economy. Inflation can fall on its own, if demand for goods and services fall and economies go into a recession. When and if the Fed starts to raise rates, the US Government will no longer be able to fund itself at levels of 3.75%; rather, they will have to pay a premium to attract investment. Either way 10 year yields of 3.75% are unsustainable unless the US economy ends up like Japan after the 90's post the Nikkie bubble!
- Conclusion – **Short US Government bonds & debt.**

The commodity bubble

- As India and China join the world economy, demand for commodities has risen to astronomical levels. Through productivity gains, cash reserves and leverage, emerging countries have improved the standard of living of their citizens.
- It is clear the commodity consumption demand from India and China is a structural change that is here to stay. However, the pace of the change is unsustainable.
- If the demand for commodities slows, commodity producing countries such as Australia, New Zealand, and Canada (who have benefited significantly) will see a sharp decline in their GDP. Add in slower consumption and a leveraged consumer, and these countries will see their currencies weaken as their central banks cut rates.
- India and China also face high inflation, weaker economic growth and excesses in both housing and credit creation. The central banks have started to tighten monetary policy, which could leave to further deterioration in GDP growth.

Conclusion

In a volatile market, Kapstream identifies four strategies:

1. Short the Euro, Pound, Canadian dollar, Aussie dollar, Kiwi versus the US dollar. Investors want to sell the currencies in countries where economies are slowing and central banks are about to cut rates. As suggested above, Kapstream recommends buying the US\$ to take advantage of the narrowing interest rate differential, in anticipation of the rising Fed Funds rate.
2. Short duration in the US, especially US Government bonds.
3. Long duration in countries that are cutting interest rates: Australia, New Zealand, UK and even Europe.
4. The credit crisis is by no means over. As Kapstream has mentioned in previous publications, continue to hold high quality fixed rate bonds in Australia that yield 8+%. As Australian banks become slow in passing down rate cuts by the RBA, their equity looks cheap as they shore up balance sheets and funding costs come down. Buy the equity and debt of the big four!