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Etsior Monthly Opinion 15 October 2009 - Thinking Asymmetric

Let's consider the current consensus:

- Given the huge liquidities injected worldwide in the economy to avoid a total collapse after the Lehman bankruptcy, the dollar will lose more and more of its value. Consequence: commodities prices will increase, the US will lose part of their power
- Considering the high current level of liquidities, we'll have a strong inflation. As a consequence gold will go the roof. Bond prices will collapse and stocks value will go down consequently
- China will have a steady moderate growth: its exports will not catch-up soon and it will no longer be the locomotive of the world economy.

And now, let's take an asymmetric view of this consensus.

Let's consider first the **dollar**. To do that one must consider China and the US as a *virtual unique economy*. China could have this extraordinary growth these last years because it had a huge export market, mainly in the US. How was this expansion financed? By a huge credit in dollars generating a huge US budget deficit. Consequently, China used its trade surplus to buy US government bonds and it is now the greatest holder of the American debt in the world. China cannot let the dollar down: its reserve would be highly reduced and its economy would desperately suffer.

Also, which other currency could challenge the dollar? The euro? Not as long as the political future of the EU is not clearer and a common budgetary policy is set-up between the eurozone countries. A quick commentary on the German decision to limit by law its budget deficit: this is potentially very dangerous for the euro and could create a conflict situation with other countries, mainly France, Belgium, Italy and Spain. Remimbi? China is not ready yet, maybe in a few tens of years. And this is not counting with the geopolitical risks. Should a major disturbance occur, the dollar will be the only safe heaven. This of course does not mean that the dollar being the only real world currency is good for the US economy: the huge deficit is obviously triggering defiance to the dollar.

Hyperinflation risk: inflation does not seem to come back. Production capacities are available everywhere, prices are stable or actually decreased these last months. Unemployment is high in the developed economies and

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probably not yet at its peak. So there is a foreseeable period without inflation. Which means that interest rates will remain at their current levels for a while, which means the bond market is still very attractive.

I would not be surprised the equity markets still go up for at least a couple of months. Among the reasons, not too bad results giving a hope of a recession exit sometimes in 2010; adjustment and productivity measures taken by companies; high level of cash of investors hurt by the crisis but who want to jump in the band wagon.

China: China will have to face different challenges in the near future. At some point it will have to somewhat diverge from the US-China virtual country we have previously described. The toll of the crisis on China has been high; both exports and imports dropped sharply. If you replace that in the Confucianism context that the Emperor must protect his citizens from floods and droughts, the Chinese government has to take appropriate measures to maintain a continuous growth and assure the comfort of the Chinese people.

This means rebalancing exports and internal consumption to the benefit of the later; rebalancing growth by investments and growth by consumption. This is what we happened this year, with short term credit expansion as well as a surge in investments. What appear to be short term measures could be in fact the *beginning of an ongoing trend*. To be able to achieve it, China at some point will have to revalue its currency and take a larger role in the world economy. This will be beneficial for China, increasing its wealth and helping fight the inflationary pressures. It will be beneficial for a more balanced world economy, allowing the US to lower their export deficit. But in any case, China is condemned to a strong growth, at least in the foreseeable future.

We care for you!

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