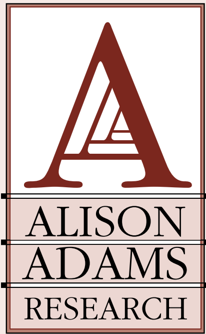


Alison Adams, PhD

617-388-9817

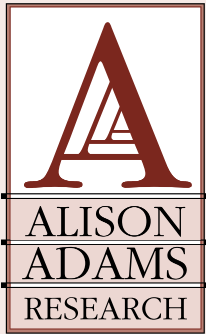
research@alisonadamsllc.com

Week 28: July 14, 2011

More yield-seeking behavior to come on Fed policy: *Bernanke will continue with ultra-low interest rates for the foreseeable future. EM currencies, commodities, and assets will benefit from yield-seeking capital flows—that is, until governments start serious intervention.*

A couple of months ago I wrote a piece arguing that Bernanke would get a U.S. economy that was not so weak it would justify an immediate QE3, but instead have a feeble economy that he would have to support with low interest rates, while the private sector put money to work in EMs instead. I love America. I wish that near-zero interest rates would create jobs here in the U.S. Sure, manufacturing is hiring some people, but U.S. manufacturing is a very small portion of the country's economy. The weak dollar might boost exports, but it is killing everyone's bottom line.

But this is really bad news in EMs. Too much money has pushed Korean and Brazilian households to boost their levels of household debt to near-record highs. In Seoul, the government is looking into new administrative measures to bring down the level of household debt. In Brazil, households may be spending as much as 30% of their income on debt servicing. China is continuing its monetary tightening. After a year of concerted administrative measures and regulation, Beijing is finally seeing property prices cool in the major cities. But in Brazil, property prices are high and only going higher.



Alison Adams, PhD

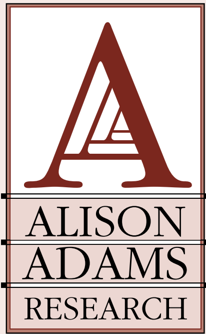
617-388-9817

research@alisonadamsllc.com

Thailand: It seems that a peaceful and relatively clean election will be neither. *Democrats try to hijack the election through the courts!*

The electoral commission is now investigating charges of electoral fraud against both the Democrat Party and the Puea Thai parties. “Experts” and officials are coming out of the woodwork charging that Thaksin himself, and not his sister, runs the Thai Puea red shirts. It sounds legal and cautious. But we have seen this movie before. The DP tried to have the TRT party disbanded on charges of fraud and connections with Thaksin. Months of red shirt and yellow shirt demonstrations ensued. There have been high-profile accusations that Thaksin’s sister promised to remove key parts of the new constitution related to the royal family and the military—an opening designed to provoke and/or justify a military intervention. While I am hopeful that the electoral commission has learned its lesson, the realist in me would argue that the newly elected Thai Puea party will not be sworn in on schedule in August.

EU convergence goes in full reverse: *Rather than facilitating the convergence of weaker economies to core levels, the EU is now being dragged down by its periphery. EU transnational political institutions are too weak and poorly designed to address the current crisis. The countries of emerging Europe, EU-4 in particular, each has the advantage of their own individual currencies, central banks, and treasuries.*



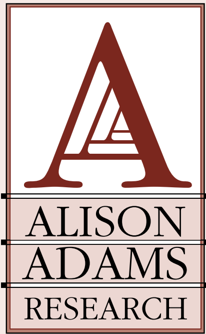
Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

Our economist in the U.K., an Argentine, is fascinated by the events in Europe. Having lived through several financial crises, the situation in Europe feels eerily familiar. As an emerging market policy analyst, I never thought that my training in EMs would be so poignantly apt for the situation in Europe. In 2009, rumors flew that the Federal Reserve and Treasury in the U.S. had hired an army of emerging market experts with experience in defaults to help sort through the MBS and bank troubles. It might be time for the EU to hire some EM debt experts as council. (I have no information on this, but I would not be at all surprised to learn that some dedicated EM debt funds are busy scooping up Greek debt. . . .)

Only a few years ago, European banks lent across borders into emerging Europe to up-and-coming consumers in Hungary, Poland, and Latvia, among others. The convergence trade was powerful and emerging European currencies surged even as European banks made extra yield on loans to these countries. The powerful idea was that the strong core economies of Europe would lift the ascendant members to first-world status and the banks would make extra profits in extending credit. Ireland, Greece, Italy, Spain, and Portugal were considered safe bets within the eurozone. The ascendant European countries did not hurt Europe—their currencies provided much-needed political and monetary protection. But this is not so for Europe's periphery. The very thing that was supposed to make the periphery a safe investment is the main vector of contagion. The shared currency is moving the convergence trade in full reverse. The periphery



Alison Adams, PhD

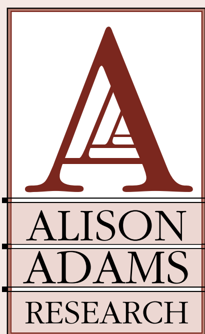
617-388-9817

research@alisonadamsllc.com

could cripple the "strong" core countries, even if the total EU debt to GDP ranking is still at very healthy levels.

BIS reports: European banks are seriously exposed to the sovereign risks of their home countries. *Domestic retail deposits in the periphery have been falling considerably since the beginning of the year. The one-third of bank-covered bonds issued since 2008 have had government securities as collateral, and banks are the nearly the sole counterparty for all government interest-rate hedges through derivatives. Troubles in Italy and Spain will be more than just an issue of solvency or liquidity; the potential for grave, systemic deleveraging is rising. "By December 2010, more than 200 banks in 16 advanced economies had issued close to one trillion Euros equivalent of (govt) guaranteed bonds. . . [this] is equivalent of 5% of GDP of advanced economies, where the pledged guarantees amount to 11% of GDP."*

Although the most recent report from the BIS was restrained, the information on the vectors of contagion between sovereign debt and banks contained some frightening information, most of which is in the appendixes. (Like the IMF, the BIS has tried to dodge political backlash.) The paper (CGFS Papers No. 43), "The impact of sovereign credit risk on bank funding conditions," sounded like it was going to be a bland read. But it was quite the opposite. Beyond the obvious statements like banks cannot have, in general, a higher credit rating than their home sovereign rating, there were some disturbing details. There are considerable feedback loops between the fiscal deficits of the home governments, falling revenues, rising NPLs, and capital-raising costs.



Alison Adams, PhD

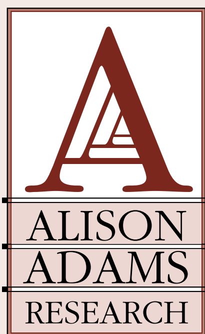
617-388-9817

research@alisonadamsllc.com

Hope that the ECB can buy enough bonds to stave off a vicious negative feedback loop is naïve. The nuclear option of an EFSF increase to 2 trillion euros seems bound to be insufficient since the fund's current mandate has the fund buying bonds at par! There is not enough money to backstop Italy, Spain, Greece, Ireland, and Portugal at par. In emerging markets, IMF "bailouts" didn't have to be so large, since between a weaker currency and the haircut in bond prices, funds could do more good for less cash.

As we wrote last week, in the periphery a subtle form of capital flight is indeed taking place. Banks are seeing their retail deposits fall as a total share of their assets. Portuguese savers would rather put their euros in a German bank than a Portuguese one. The financially savvy, in anticipation of a major default or even the break-up of the currency union, will move their deposits to "safe" banks. The EU bank stress tests will inevitably exacerbate this trend. On the one hand, you could say what's the difference, the euros are euros. But since the 2009 agreement that each EU member state will guarantee its own home banks and their foreign branches, banks from the periphery will become even more dependent on the financing and liquidity of their home governments. They are already shut-off from wholesale funding from other banks in the EU due to prohibitive costs. To lose retail deposits as well will be a serious blow.

Big banks in Europe's core hold considerable exposure to the PIIGs and these numbers have claimed many headlines over the past year. German, French, and Belgian banks hold at least 20% of their Tier 1 capital in sovereign bonds from the periphery. But the OTC derivative



Alison Adams, PhD

617-388-9817

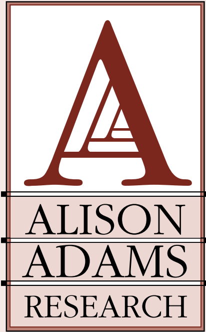
research@alisonadamsllc.com

interest-rate exposure to sovereign risks is considerable. The mark to market risk from derivatives on bank books in the face of such strong interest rate moves is also great. Posting collateral on these interest-rate derivatives could be costly.

Food price inflation: USDA and corn. The *USDA increased its corn stockpile estimates by 3.7%. China is hopping mad—why do crop projections change so much? In the U.S., corn ethanol consumes more corn production than livestock feed. More U.S. corn plantings and more U.S. corn ethanol production will do little to alleviate global grain reserve shortages. Meanwhile, China's food prices have risen over 14% in the past year! Beijing has pledged to do more to boost local agricultural production and supply more pork.*

A couple of years ago, a Chinese official charged with copper purchases lost a massive amount of money speculating in copper. The political fallout in Beijing was supposed to end that kind of "cowboy" speculation and hedging in favor of more conservative purchases. Well, that was what the officials said at the time. But in practice, commodity speculation is very much alive and well in China. I would not be at all surprised to learn that local governments used bank loans to speculate in commodities through their SIVs. That might have been easy money in 2009. But Beijing is in a very different mood and full inflation-fighting mode.

It is possible that with the PBoC cracking down on bank lending and soaking up excess liquidity, we could see more high-profile commodity purchases lose money in the coming months. Like



Alison Adams, PhD

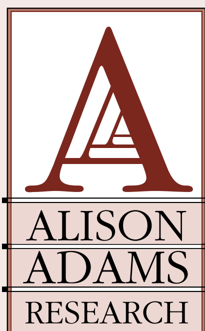
617-388-9817

research@alisonadamsllc.com

hedge funds in the U.S., the new slate of data from the USDA has thrown grain speculators under the bus. And in China, officials are apparently grumbling. According to Bloomberg, an official from China National Cereals, Oils and Foodstuffs Corporation (COFCO) complained about the fluctuating crop predictions from the USDA. Fei Zhonghai spoke at a Global Derivatives Forum in Dailan. "I would like to question the U.S. Department of Agriculture in just 10 days or less than a quarter of the year, why does your corn data differ so much? . . . One time it was as high as heaven, while another time it was as low as hell . . . . companies like us are unable to hedge on the futures market, it may bring huge losses to our enterprises."

Twenty years ago, crop predictions in the U.S. probably changed just as much as they do now. But the army of hedge-fund and commodity-fund experts has placed staggering amounts of money on U.S crop yields and bets around the world for grain prices. The CFTC now has good data to indicate that well over 80% of grain future contracts are made by pure financial speculators. Derivatives contracted all over the world reference the CBOT and the NYMEX prices, which are now controlled by pure speculators.

U.S. farmers may have planted substantially more corn than the USDA had originally forecast. Certainly high corn and wheat prices would have prompted such a supply-side response. But there is more news. There will be more corn at the end of the year, but corn ethanol producers will be there to take a substantial share of that production.



Alison Adams, PhD

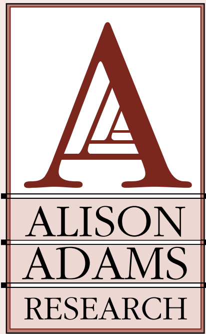
617-388-9817

research@alisonadamsllc.com

On a positive note, good rains in India have officials raising their crop estimates for this year. I do not believe that Indian officials are any more accurate than U.S. officials in predicting harvest volumes. But a good harvest ought to help alleviate some headline inflation numbers in India by the end of the year. In China, Beijing is redoubling its efforts to boost agricultural production and increase the supply of pork. Food prices have risen 14.4% in a year in China. There is a strong political incentive to bring down food prices since food prices are considered to be a main driver of political discontent.

Crude and global growth: *With most of emerging Asia looking at slower growth going forward, demand drivers for higher crude prices are weaker than in 2010. But the promise of extended ultralow interest rates from the Fed could push up prices anyway.*

I was happy to read that the Saudis profited handily over the past year, seeing their oil profits rise from $153bn in 2010 to $324bn this year. Meanwhile, Iran, which has been difficult and obstructionist for years, only saw its oil profits rise around $25bn this year. Maybe Iran would have made more money if it had actually been able to pump a larger amount of crude and was not such a difficult partner in oil exploration and production. In Venezuela, the government is issuing more debt with an eye toward boosting social spending. That country is probably suffering for lower-than-expected oil revenues as well.



Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

But while the market was somewhat pleased by the slightly better-than-expected GDP numbers out of China, the official message from Beijing is still full inflation-fighting mode. Crude imports fell by an estimated 11.5% in June over last year's numbers. VLCC tanker sailings from the Middle East to Asia have also fallen. Only 75 tankers sailed to Asia last month while last year during the same period 98 tankers sailed.

The IEA has reduced its planned SPR release, perhaps on weaker demand expectations. The Saudis have increased production but seemingly not as much as they had promised. Demand might be weaker than they anticipated.

Alison Adams Research

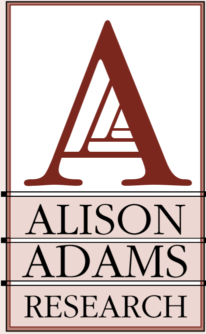
Mobile: 617-388-9817

Office: 617-475-5295

Email: research@alisonadamsllc.com

The information in this report has been taken from sources believed to be reliable by the authors of Alison Adams Research who do not warrant its accuracy or completeness. Any opinions expressed herein reflect the authors' judgments at this date and are subject to change.

Alison Adams Research does not assume any liability for any loss which may result from the reliance by any person or persons upon any such information or opinions. These views are given without responsibility on the part of Alison Adams Research. No part of this report may be reproduced or circulated without the prior written permission of the issuing company.



Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

This document is for private circulation and for general information only. It is not intended as an offer or solicitation with respect to the purchase or sale of any security or as personalized investment advice.