



DOLLAR STRENGTH, THE LATEST BUBBLE?

The collapse of financial markets instigated by the sub-prime phenomenon has led to wide spread panic and heightened risk aversion. The result: huge flows of capital to the United States and significant dollar strength, the degree of which has aroused interest amongst leading economists, the question being asked, "Is this dollar strength another bubble?"
Written by Marc Schroeder - NFB East London

For many years the dollar has been regarded as the world's reserve currency; after all commodities are priced in dollars. Central banks therefore accumulate hordes of dollar reserves, particularly during flush economic periods, the purpose being to protect their respective currencies in the event of any global economic threats. During the last decade, most countries have been bathed in cash as yield-thirsty investors (mainly American) have fed mainly borrowed money into the global economy, pushing commodity prices up way beyond reasonable levels. During these times reserve banks around the world managed to drastically increase dollar holdings. Then came 2008, sub-prime, the unwinding of grossly over speculated asset prices and the global slowdown.

Panic driven investor sentiment saw dollars fleeing from emerging markets and retreating to the safety of the United States. Treasury bills were in hot demand and at one point investors were willing to accept a negative yield to protect capital. Most emerging market currencies took a clobbering; our rand lost as much as 50% against the dollar and our currency was not alone as the pound and euro counted their fair share of casualties against the overbought dollar.

This dollar strength has been created out of irrational and bizarre events and for that reason investors should be concerned over the sustainability of this strength. There are strong arguments that support the flight away from dollars as the world begins to rationalise. One such argument is how countries around the world will now service their trade and budget deficits so to protect their currencies. All nations, emerging and developed, are facing the same problems in terms of global demand for their produce. Let us look at these countries in categories:

1. Emerging Markets

Emerging markets usually run current account deficits. These have been traditionally financed by capital inflows, such as tourism. The global slowdown now means that capital inflows have dried up, resulting in depreciation of emerging market currencies. The biggest defense an emerging market has is its dollar reserves, which can be brought to the market now at unusually strong dollar levels.

2. Developed Markets

With a general shift in demand away from goods produced in expensive operating environments to more efficient producers such

as China, most developed nations are experiencing severe pullbacks in sales. Many countries are now facing budget deficits as tax revenues diminish and this will put pressure on leading central banks to start selling dollars to maintain a level of liquidity to ensure fiscal continuity. The US is amongst this group. They are exporting less than they are importing. The visible solution to financing their massive trade deficit is to print more money or issue more treasury bills (which is pretty much the same thing).

3. Resource Intensive Markets.

These are markets whose primary produce is dollar priced commodities. The strongest example would be the oil producing nations such as Saudi Arabia. With the oil price sliding from \$150 a barrel to below \$40, profits have been bludgeoned. All dollar profits made in recent years are under threat as these countries are now dealing with budget deficits.

With trillions of dollars potentially up for sale, and with investors accepting that the dollar is yielding a negative real yield (the fed rate now at 0.25%) a reversal of the demand for dollars witnessed over the past year may not come as a surprise. Investors will eventually start looking to protect the purchasing power of their currencies. If this happens, the question will be 'where will the money flow to?' Higher yielding currencies (such as the rand), commodities, property and bonds should do well as interest rate differentials (and thus their appeal) become exceedingly apparent. As money leaves the States, so too will sentiment spurring dollar strength. To make matters worse, the States is experiencing historically high levels of unemployment. The US government will have to further its bailout packages over and above those to ailing corporates, banks and state treasuries; this will mean printing more dollars. The more bailout packages issued, the more diluted the strength of the greenback. All this at a time where the US is regarded as the most indebted nation of all time.

It must be stressed though that as long as uncertainty exists, investors will take cover under the dollar, despite the reasons mentioned above. With no perceived end to the economic drama one can expect the dollar to continue strengthening in the medium term. ⚡

For more information relating to foreign currency and offshore investments please contact your financial advisor.

Contact us:

Johannesburg Office: NFB House 108 Albertyn Avenue Wierda Valley 2192, P O Box 32462 Braamfontein 2017, Tel: (011) 895-8000 Fax: (011) 784-8831

East London Office: NFB House 42 Beach Road Nahoon East London 5241, P O Box 8132 Nahoon 5210, Tel: (043) 735-2000 Fax: (043) 735-2001

E-mail: nfb@nfb.co.za Web: www.nfb.co.za

FROM THE CEO'S DESK

As I pen this editorial we have enjoyed a rally from 18,000 to approximately 22,000 on the JSE and we have, since I last penned an article, seen the rand fluctuate, quite violently, between the low- to mid-tens and the low nines. This has happened locally whilst overseas, in both developed and developing economies, they are licking their wounds and wondering what 2009 holds in store.

I guess that we need to take stock and try to understand, in a sea of uncertainty, what markets hold in store for us and what our income needs are, having made ourselves comfortable with the portfolios ability to deliver this income; probably being sourced from more conservative and capital protected assets, leaving the balance of capital in growth oriented assets and investments. There, they still face a strong probability of headwinds; the strength of which cannot be predicted. What is clear is that the key economies, and therefore our major trading partners, are in a much worse shape than S.A. The question we then have to ask of ourselves is: what does this mean for both our local and offshore investments. Domestically, we have the SARB dropping rates. This will serve to soften the blow and lessen the impact of the recessionary risk permeating our economy; driven by the dire positions the US, Europe and the UK find themselves in. We also have a situation where massive government spending on infrastructure and other key areas is taking place. This will also act as a buffer whilst the hard hit consumer and nervous-to-commit-corporate take a breather and wait for the, hopefully material, drop in interest rates. This drop will, as it always does, have the eventual effect of stimulating the economy by making borrowing cheaper, as well as making equity and other growth oriented investments more attractive to investors, as rates of return on the safer bank deposits reduce to unattractive levels.

A further very notable change is the rather material drop in the capital market rates. This market is typically where the government, parastatals and corporates go to raise money for large, longer term projects. This drop indicates that smart money has been flooding into long term fixed rates of return, predictive of significant drops in the short- to medium-term cost of funds. I believe that we might even see prime breach its previous lows of 10.5%; achieved at the bottom of the last down cycle in rates. The caveat here is that it will take longer, after some initially fairly aggressive cuts, to reach these lows.

The Achilles Heel in this space is the rand. We are in an election year; not traditionally regarded in our country as a place or time when reason prevails. Look out for crazy and often inflammatory commentary by selfish, self-serving politicians. Add to this the sensationalism typically added by the media who, whilst often being very competent, do still have a commercial imperative, i.e. sell advertising and get their ratings up by selling news.

Given that good news doesn't have the appeal that bad news has, watch this spot! If rates come down quickly, complemented by negatives on the political front, our currency will be hammered. I believe that the rand has had it too easy in the last while and will weaken over time. Our inflationary expectation is still high relative to our trading partners and this makes our currency vulnerable; even without the added pressure that the aforementioned facts could add.

Whilst things sound pretty gloomy, and they are, take a look at the fate of some other markets and celebrate the moderacy of our turbulence compared to the fate of others. These numbers represent the market losses to mid November 2008:

Iceland	-89%
China	-64%
Russia	-64%
India	-48%
Hong Kong	-46%
Brazil	-40%
Japan	-40%
USA	-36%
Australia	-35%
UK	-32%
New Zealand	-29%
South Africa	-26%

These rather crazy drops in some markets reflect a world in loads of trouble. The excesses of the last decade of relentless printing of money and granting of credit have come home to roost. The cure is not pleasant and I would predict loads of pain being taken in the next year or two. The key point is that there is a rainbow out there. We need to be patient, watchful and brave when opportunities present themselves.

I, on behalf of the NFB teams in East London and Johannesburg, would like to take this opportunity to wish our clients, staff and institutional partners the very best of health and good fortune for the year ahead.

Mike Estment, CEO



IN THIS ISSUE

from the CEO's desk

the paradox of thrift

dollar strength, the latest bubble?



financial services group

The Paradox of Thrift

thrift...

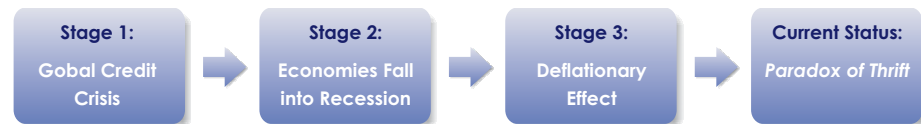
Noun

1. extreme care in spending money;
2. reluctance to spend money unnecessarily
3. frugality [syn: parsimony]

Source: www.dictionary.com



To say that 2008 was a tumultuous year may be an understatement, the phrase *annus horribilis* is possibly more apt. With the series of devastating events that shook the very foundations of the global financial markets we are left facing the question: where does the global market currently stand? Written by Alistair Holmes – NFB Johannesburg



Stage 1: Global Credit Crisis

The much scrutinised and much publicised Sub Prime Crisis, which, in essence, was the degenerative lending habits of the US mortgage market repackaged into complicated structures, lead to the Global Credit Crisis and has had an inconceivable domino effect the world over. As a result of the consequent tumultuous markets there was a mass exodus from emerging markets; with a reported US\$48 billion being repatriated to what was perceived as “safe” markets. This flight to quality was fuelled by fear, both fear of further losses and fear of the unknown; investor’s sentiment was to evade risk. This later proved to be a strategy that was fraught with as much risk as it sought to avoid. What was perceived as safe didn’t entirely materialise as dozens of established companies were wiped off the financial landscape.

The withdrawal from emerging markets was felt locally on all fronts. With over 50% of equity on the JSE owned by foreigners, and our bond market being one of the most liquid in the world, we soon saw massive

amounts of foreign investment leave our shores, leading to the rand selling off. Unfortunately, one of our greatest attributes, a highly liquid currency and equally liquid exchanges, lead to our currency’s demise. Fortunately, however, the full wrath of the Global Credit Crisis was side-stepped as a result of our high interest rates, which US investors would have seen as extremely attractive, and our stringent exchange control policies, which would have prevented local investor’s funds from being expatriated, resulting in further withdrawals from our exchanges and further selling off of the rand. The NCA (National Credit Act) played a supporting role in softening the harsh blow of the Global Credit Crisis (see side box * for further details).

To contextualise the appeal of our interest rates versus the corresponding rate available in the US, please see the table below (note that the table excludes the consideration of currency and sovereign risks).

Date	RSA Interest Rate	USA Interest Rate	Degree of Attractiveness
Nov 2007	10.50 %	4.50 %	2.33 times
Feb 2008	11.00 %	3.00 %	3.66 times
Jun 2008	12.00 %	2.00 %	6.00 times
Oct 2008	12.00 %	1.00 %	12.00 times
Dec 2008	11.50 %	0.25 %	46.00 times

Stage 2: Economies Fall into Recession

A natural consequence of the Global Credit Crisis was the deleveraging of balance sheets, which in itself lead to further deleveraging (known as the Deleveraging Effect). Banks then were not in a position to lend anymore. With the lack of financing, businesses could not embark on new or complete existing expansion projects which would have stimulated the market and the overall economy, and consumer spending suffered in a similar manner (Joe Sixpack’s credit card was fully loaded and no one was willing to finance his next plasma screen). Economies have ground to a standstill, and in many cases have gone backwards. This slowing of individual economies is highly likely to send the world into a recession; one of the few passages in history in which economies around the world experience recessionary conditions at the same moment in time.

Stage 3: Deflationary Effect

The culmination of this series of events is global deflation. The demand for goods and services has declined significantly as a result of three main motivators. Firstly, people are being more prudent and saving as much as possible in these turbulent times. Secondly, as a result of the recession many people have been laid off, this removes them from the spending force of the economy. Thirdly, people who are still in a position to spend on goods and services will notice the drop in prices, as a result of the drop in demand, and will hold off from purchasing in order to ride the deflation wave; benefiting from lower prices in future. All these factors continue to fuel the recession; which in turn is deflationary.

It is pertinent to note that although inflation locally is inordinately high, the inflation figures are a lagging indicator. Hence they are not an indicator of the current conditions. There are indications though that these figures are starting to decrease, lending itself to a disinflationary environment.

Current Status: Paradox of Thrift

The Paradox of Thrift arises because what is good for the individual is not necessarily good for the economy as a whole. Whilst it is appropriate and prudent for individuals to tighten their purse strings,

for them to be a little more frugal, and to accumulate savings in these difficult times it does mean that there are far less consumers out there doing just that, consuming. Economics 101 suggest that gross savings in an economy equates to gross investment, that is the amount that is saved by individuals is available to be lent on to institutions and individuals who then put these assets to productive use. The translation mechanism between savings and investment is the global banking industry, which at present is mired in the Global Credit Crisis and is unable, and in many cases unwilling, to translate savings into lending activity, preferring instead to repair the miserable holes in their own balance sheets. And for as long as individuals continue to save and pursue their own needs, and for as long as the banks continue to pursue their own needs the global economy will continue to suffer (the paradox of thrift: as what is good for the individual may be bad for the individual in the long-run).

Solution: How and when does it stop?

The good news is that there is a light at the end of the proverbial tunnel. There are two avenues which would lead to the correction of the investment and savings system.

First and foremost, interest rates need to come down (and they have, dramatically. Particularly in developed markets and, in very short order, developing markets as well). With finance being more accessible, saving is discouraged and the acquisition of debt is encouraged, resulting in a rejuvenation of industry. This allows for the creation of jobs for those who lost theirs, which leads to income being poured back into the economy. The thrift approach will be subdued as people will have a sense of comfort as other facets of the financial landscape prosper.

Here in South Africa we are fortunate in the sense that we are in a position of having interest rates at a level that they can be cut fairly substantially. Who would have thought we would be praising high interest rates, whereas a country like the US has such a low central rate that they don’t have the tools to deal with the crisis. Our monetary policy, exchange controls and National Credit Act have served their purpose and aided us at time when we needed it most, during what in all likelihood will be one of the worst set of economic conditions we will experience in our investing careers.

The other avenue for breaking the paradox of thrift is by government intervention. By government spending money, through launching development projects such as building infrastructure, the economy will be stimulated.

Again, locally we are in the fortuitous position of our government having budgeted to spend over a trillion rand on the development of infrastructure in South Africa over the next business cycle. This will lead to jobs and ultimately spending to ensure our economy is a stable one.

As it is in nature, so it is in investing, economics and market conditions. All things have their time and their cycles, this is a particularly difficult one as certain paradoxes need to be overcome and the global banking systems needs to be restored to health but, with time, they will be overcome and health will be restored. At which point we, as investors, would do well to reflect back on times like these and apply the lessons learned, for if there is one all-consuming mistake investors- and humans-alike make, and that is to make the same mistakes that we did the last time. ☞

* National Credit Act: The *unsung hero*...

The National Credit Act came into effect on 1 June 2007 and replaces the Usury Act and the Credit Agreements Act. The Credit Act is there to prevent people from spending money they don’t have, to help the banks manage the massive credit debt this country has, and help stop reckless lending by the banks.

There are few amongst us that didn’t perceive this as a draconian piece of legislation. The restraints seemed to be just another layer of bureaucratic red tape, which prevented us from what we perceived we could afford. The average US household has 10.5 credit cards, this is the type of thing the NCA has prevented. The financial strains of the past 18 months would have been heightened if there weren’t such impositions.