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AFTER THE STORM: MAKING SENSE OF THE INVESTMENT OUTLOOK A SUMMARY OF THE 2009 BCA INVESTMENT CONFERENCE New York - October 19-20, 2009

Setting The Scene

Martin Barnes opened the conference by expressing his uneasiness with the financial and economic outlook, a sentiment that was later echoed by numerous other speakers. Last year it seemed that the world came close to "the end". The world appears much better today and U.S. equities have more than doubled, but Martin questioned whether it could be that easy to revive the economy following such a large shock. He expressed a nagging feeling that "something bad" is still lurking.

Given that this is the 60th anniversary of BCA, Martin wondered what BCA's founder, Hamilton Bolton, would think if he were alive today. Bolton would probably be amazed that the system could last this long with such a heavy debt burden. Martin surmised that Bolton's outlook for financial markets would probably be torn between the threat from high debt levels and the tailwind from ample liquidity.

This year's BCA conference incorporated the use of an Automated Response System, which allowed moderators to gauge the views of the audience on various policy and investment issues. The results will be sent to clients in the coming days.

The Future Of The Financial Services Sector

Henry Kaufman

President, Henry Kaufman & Company, Inc.

Arthur Levitt

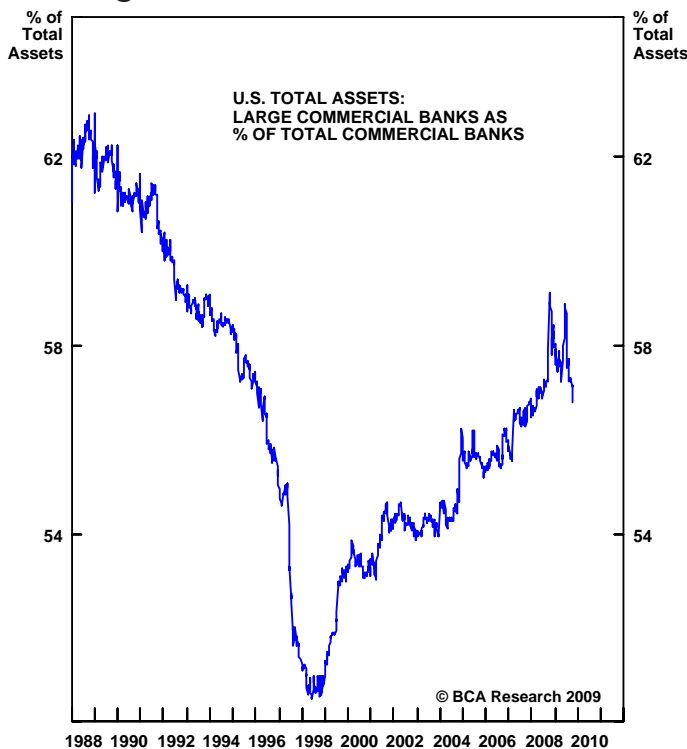
Former Chairman,

United States Securities and Exchange Commission.

Henry Kaufman noted several factors that contributed to the financial crisis:

- The dramatic transformation of markets due to deregulation.
- Rapid financial innovation increased the ability to take risk, and shifted it from banks to other parts of the financial industry.
- Leverage has surged and the perception of liquidity has changed from the asset side of the balance sheet (i.e. cash and liquid assets) to borrowing capacity. Part of the reason was that investment banks shifted from partnerships (personally liable entities) to corporations (with limited liability). This change boosted the incentive to add leverage.
- The financial industry has shifted from clearly defined financial institutions to conglomerates that dominate the industry (**Chart 1**).

CHART 1
Large Banks Dominate



Mr. Kaufman argued that the crisis has brought with it several macro and market implications:

- *Economic growth will be slower.* Financial innovation and deregulation has boosted economic activity over the past 25 years, but the pace of expansion was always unsustainable. In the future, growth of credit will be considerably slower (partially due to increased regulations) and the household saving rate will remain elevated.
 - *There is an increased risk that monetary policy will become political* because of the poor performance of the Fed over the past 20 years and its inability to recognize risk and the structural changes brought by the ending of the Glass Steagall Act. Moreover the central bank now has a bloated balance sheet and unwinding its mortgage securities portfolio will be a challenging task that will be influenced considerably by Washington.
 - *Socialization of the financial system.* Residential finance (Fannie Mae and Freddie Mac) will remain government controlled, because the government can borrow more cheaply, influence lending, and limit risks for the housing sector. There is no political will to privatize the GSEs. Secondly, the Fed used an asymmetric approach to monetary policy by protecting systemically important financial conglomerates. Leaving these conglomerates “too big to fail” will encourage ongoing political influence.
- Kaufman does not have a great deal of hope for strong or effective financial regulation, but argues that it is needed. He notes that the failure of supervision does not mean that regulation is undesirable. In his words, an absence of regulation would be tantamount to opening all the doors at the zoo. To avoid regulatory arbitrage, global cooperation for regulation is needed.
- Arthur Levitt highlighted that there are plenty of villains to blame for the financial crisis (including bankers, lawyers, and rating agencies among others), but the largest is the lack of congressional oversight due to the influence of campaign contributions. Levitt argued that intelligent regulation (not necessarily more regulation) is needed, with a focus on risk management. However, he is not very optimistic about the regulatory outlook:
- The likelihood of effective regulation is inversely correlated with the level of risk asset prices. Congress only acts in a time of crisis and the opportunity may have passed now that equity prices have recovered strongly.
 - There is less than a 50% probability of regulation for consumer protection, as banks appear to be effectively lobbying the government.
 - Derivative regulation will be diluted substantially.
 - Global regulatory coordination (i.e. international accounting and regulatory standards) is unrealistic in the near term.
 - It is impossible to effectively regulate financial compensation.

- One important proposal before Congress would allow investors to sue the rating agencies, but this probably will not pass.

Levitt also believes that the U.S. needs a systemic regulator to survey the whole financial landscape in search of threats to the system. The White House recommends the Fed for the job, although he thinks that the Fed would have to give up some of its other powers. The Senate banking committee recommends a council of regulators, but this approach would be bureaucratic and slow. Levitt prefers a resolution authority that could warn shareholders and bondholders when it identifies a “too big to fail” institution. The resolution authority could also decide how these institutions would be wound down in the case of failure.

The Long-Run Outlook For Energy

Charles Maxwell

Senior Energy Analyst, Weeden & Co.

Philip Verleger Jr.

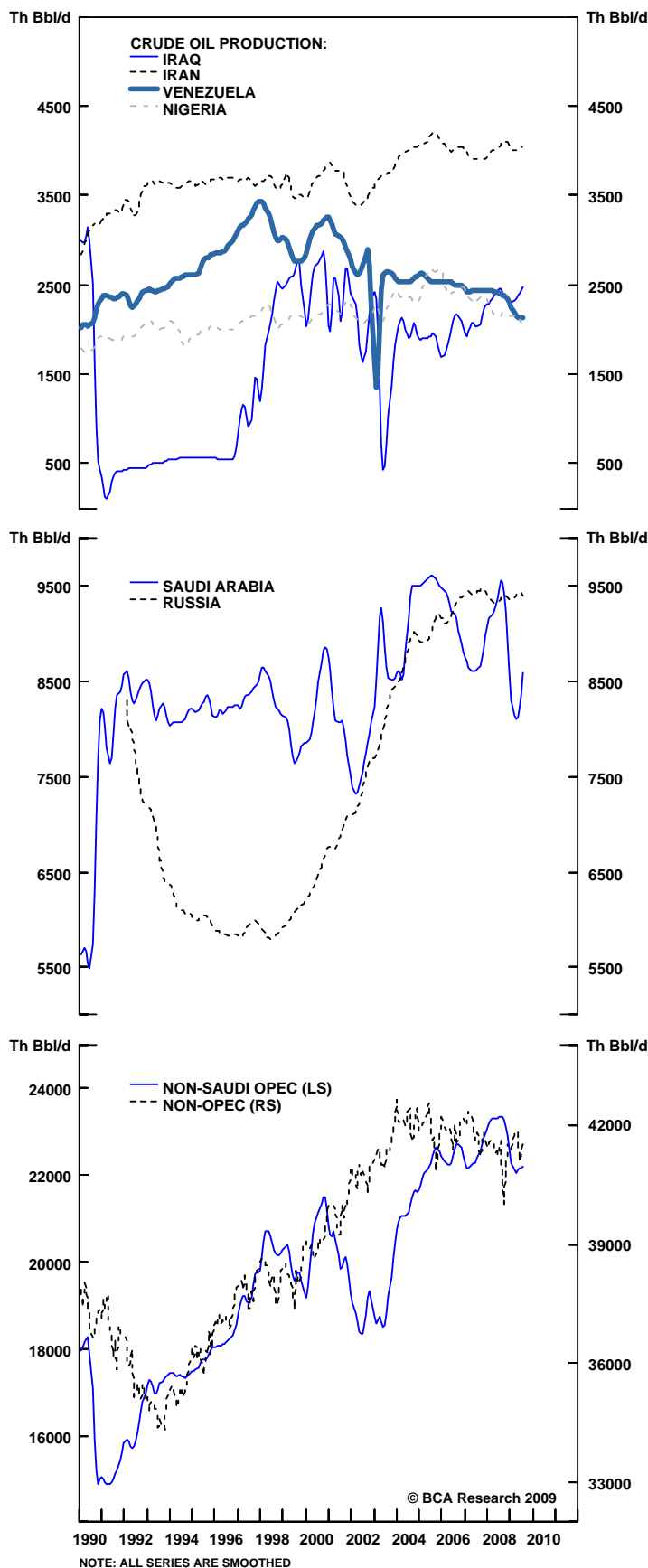
David Mitchell/EnCana Professor at the Haskayne School of Business, University of Calgary

David Abramson

Managing Editor, BCA Commodity & Energy Strategy

Charlie Maxwell opened by arguing that the world will need a lot more energy to accommodate global growth, especially in the emerging world. However, the world’s ability to produce oil is peaking. Big oil discoveries are not as plentiful as they were, and explorers have to dig much deeper than in the past to find and recover crude. Most of the big pools of oil have already been tapped. Environmental and political constraints are making it harder to exploit the reserves that are available. Moreover, investment in this area is insufficient. Governments are not thinking ahead to long-term supply issues. The peak of non-OPEC oil supply was in 2007 (**Chart 2**).

**CHART 2
Oil Production Has Peaked**



The transition away from cheap fuels (coal, oil & gas) to cleaner energy will be gradual (e.g. the majority of car sales still will not be electric vehicles in 10 years time). This means that oil prices have substantial upside potential.

In the long-term, shale gas and nuclear energy will help to solve the world's energy problems, but only beyond the next 10-15 years. In the short/medium-term, we need to focus on energy efficiency/conservation and alternative energy. The government should encourage investment in these areas and, indeed, the Obama Administration is supportive.

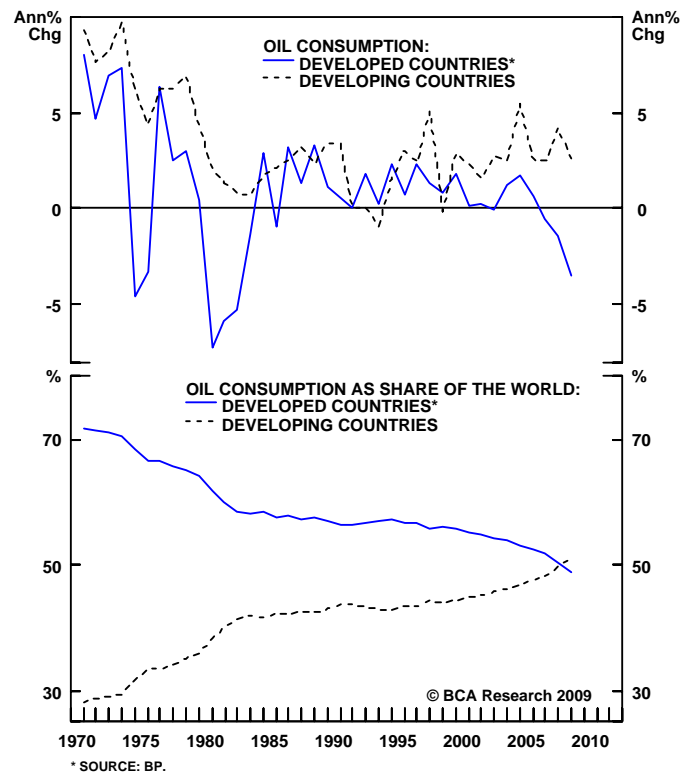
Philip Verleger emphasizes peak oil consumption, not supply. He believes that world oil consumption may have peaked at 86m/b/d. What caused oil prices to spike at \$147/bbl last year? It was due to new regulations that required the reduction in the sulphur content of diesel fuel, as well as the disruption of light sweet crude oil supply in Nigeria, which produces about 25% of total global light sweet crude. As a result, refiners bid up light sweet crude because of its low sulphur content (capacity to refine heavier crude is limited), thereby driving up all crude prices.

Verleger is bearish on oil prices in the next few years for several reasons:

- Below-trend global growth will temper the demand for energy. The range of 80-85 m/b/d is a realistic estimate for global oil consumption.
- The Obama Administration dislikes the oil industry and Congress is pushing for alternative energy.
- Natural gas is increasingly used for electricity generation. As natural gas infrastructure is built, it will depress the demand for oil.

Mr. Verleger believes that oil prices will come under severe downward pressure when the Fed starts to normalize policy. The price of oil could collapse and the magnitude of the decline will be larger the higher that oil prices advance in the meantime.

CHART 3
EM Will Drive Oil Demand



BCA's David Abramson argued that cyclical factors (demand vs. supply/inventory) are consistent with a \$35/bbl fair value, but structural factors are consistent with \$85/bbl, due to EM demand (even with no allowance for geopolitical risk). The "paper demand" for oil (and commodities more generally) by long-term investors is rising structurally, which helps to explain why oil prices began to rise along with the leading economic indicators in this cycle, rather than with coincident economic indicators as is normally the case. As long as China can grow at an 8-9% pace on a sustainable basis, higher oil prices do not require the revival of demand in the U.S. (**Chart 3**).

Mr. Abramson also made a few comments on the price of gold, projecting that it could reach \$1200-1300 by year end. Gold prices do well in the phase of the business cycle when the economy is bottoming but before central banks begin tightening. Gold prices could drop if there is a "double dip" in the economy. However, if investors decide that they need

more inflation protection in their portfolios, even a small swing in allocation toward gold could spark a major overshoot in prices (a mania is possible).

The speakers also addressed potential new regulation in commodity markets. Verleger argued that there a risk the CFTC would impose position limits on banks thereby reducing commodity companies' access to capital, although this risk recently has subsided. However, Congress is still threatening to limit the influence of commodity ETFs.

Finally, our panel provided the following oil price forecasts:

Oil prediction at the end of 2010:

Verleger – \$40-70/bbl

Maxwell – over \$70/bbl

Abramson – \$80-85/bbl

Oil prediction over the next 10 years:

Verleger – \$25-200/bbl

Maxwell – \$50-200/bbl

Abramson – \$100-150/bbl

PROSPECTS FOR THE FIXED INCOME MARKETS

David Kotok

*Chairman and Chief Investment Officer,
Cumberland Advisors*

Ronald Torrens

Managing Editor, BCA U.S. Bond Strategy

David Kotok argued that the U.S. is addicted to the use of the "federal guarantee", now that the authorities are backing private sector debt that represents over 100% of GDP. The authorities will not be able to withdraw that guarantee for a long time. David believes that investors should take advantage of the federal guarantee by buying debt with

an implicit government guarantee such as Build America Bonds, rather than fight it.

David warned that the Fed risks becoming increasingly politicized. The Democrats blocked the previous Administration's attempts to fill two governor positions at the Fed. Since there are only five governors, (one of which is now an Obama appointee) each one effectively has a veto over the use of the Fed's emergency powers such as when it negotiated an orderly windup of Bear Stearns last year (because a "super majority" of five out of seven governors is required to make decisions in this case). The unfilled governor positions make the Fed more prone to political interference, although not in terms of setting the fed funds rate since some regional Fed Presidents also vote on interest rate changes. The implication is that the Fed may be under pressure to maintain its "emergency" market support for longer than Fed policymakers think is appropriate. The Fed's independence is being threatened according to David.

However, Mr. Kotok argued that massive stimulus is more likely to provide asset inflation than consumer price inflation in the near term. Investors should watch the private credit multiplier and labor income for signs that inflation risks are rising. It may be a long time before consumer price inflation accelerates in David's view. He is also not concerned about the impact of the federal budget deficit on Treasury yields, highlighting that federal debt exceeding 200% of GDP in Japan has coexisted with low inflation and low bond yields.

On municipal bonds, Mr. Kotok argues that there is no chance of any state defaulting. He is bullish, but cautions that we need to be selective in security selection. The corporate bond rally is well advanced in his view. Mr. Kotok recommends Brazilian inflation-linked securities for investors seeking inflation protection. TIPS are vulnerable to rising Fed tightening; they are currently overpriced and offer no real value.

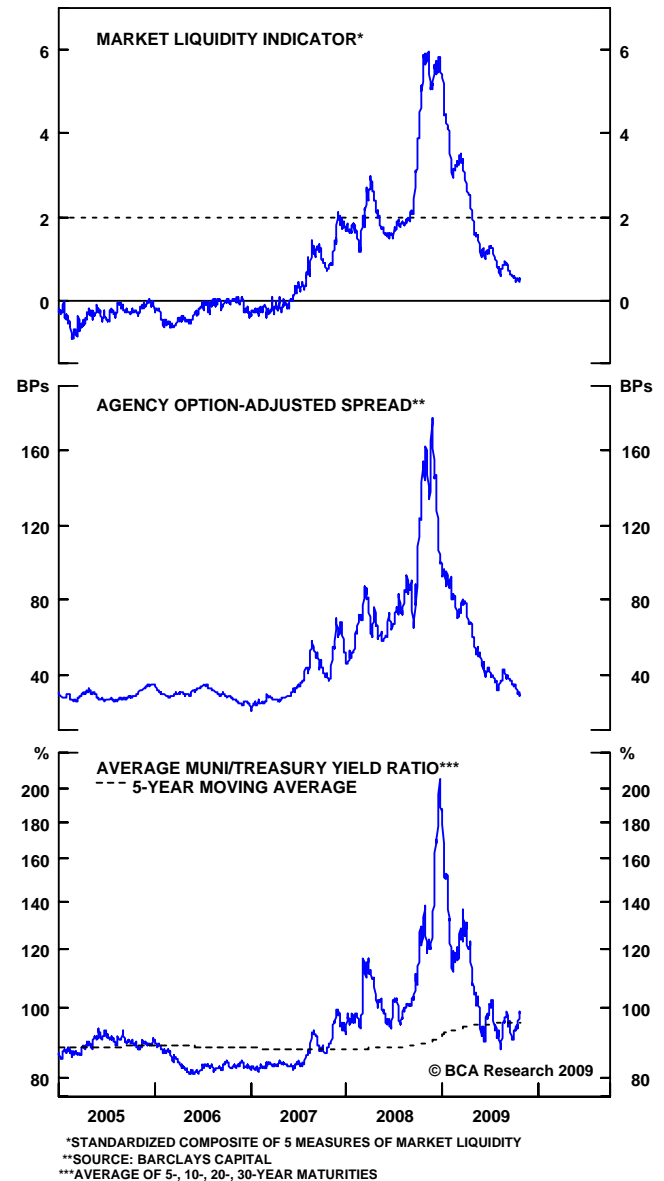
Ron Torrens began with a pair of admonitions: first, don't underestimate the importance of excess capacity in the economy – the recovery from the housing bust is a multi-year event and the persistent supply side excesses have the power to change the underlying trend in inflation. Second, don't underestimate the fiscal and monetary response to the crisis. They have both been massive. Additionally, these efforts act with a lag, and are not all yet in place. Therefore, there is still a large boost to growth on its way which has not been fully recognized.

Consequently, inflation will be in a persistent downtrend, but growth could rebound, perhaps more sharply that is currently discounted. For Treasury securities, these are offsetting forces and argue for range-bound yields. Tactically, this means bond investors should sell the 10-year Treasury near 3-3¼%, but buy it back near 4% in the near term. On a longer term (3-5 year) horizon, the yield could reach 5-6%.

Conversely, the combination of falling inflation and accelerating growth is very powerful for risk assets and warrants an overweight to spread product as an asset class versus an underweight in Treasury bonds.

Torrens then discussed two additional themes important to spread sectors. The first is to favor liquidity over credit risk. During the worst of the liquidity crisis, high quality assets became relatively cheap. Once the Fed had assured investors that it would do "whatever it takes" to restore market order, these sectors (agency bonds, municipals and TIPS) were natural overweights since they had the most to gain as the liquidity premium component came out of spreads (**Chart 4**). This opportunity has largely dissipated and he has gradually moved down in quality as liquidity came back and a more normal balance between the two components of the spread was restored.

CHART 4
Liquidity Premia Have Evaporated



But the second theme – to buy what the Fed is buying – is still very much in force and supports a higher allocation to those groups – MBS, ABS, and even high quality CMBS – than might otherwise be the case given the current environment. In sum, spreads have room to narrow, against flat-to-rising Treasury yields.

Key Themes For Investment Strategy

Russell Napier

*Global Macro Strategist,
CLSA Asia-Pacific Markets*

Francis Scotland

*Director of Global Macro Research,
Brandywine Global Investment Management*

Chen Zhao

*Managing Editor,
BCA Global Investment Strategy*

J. Anthony Boeckh

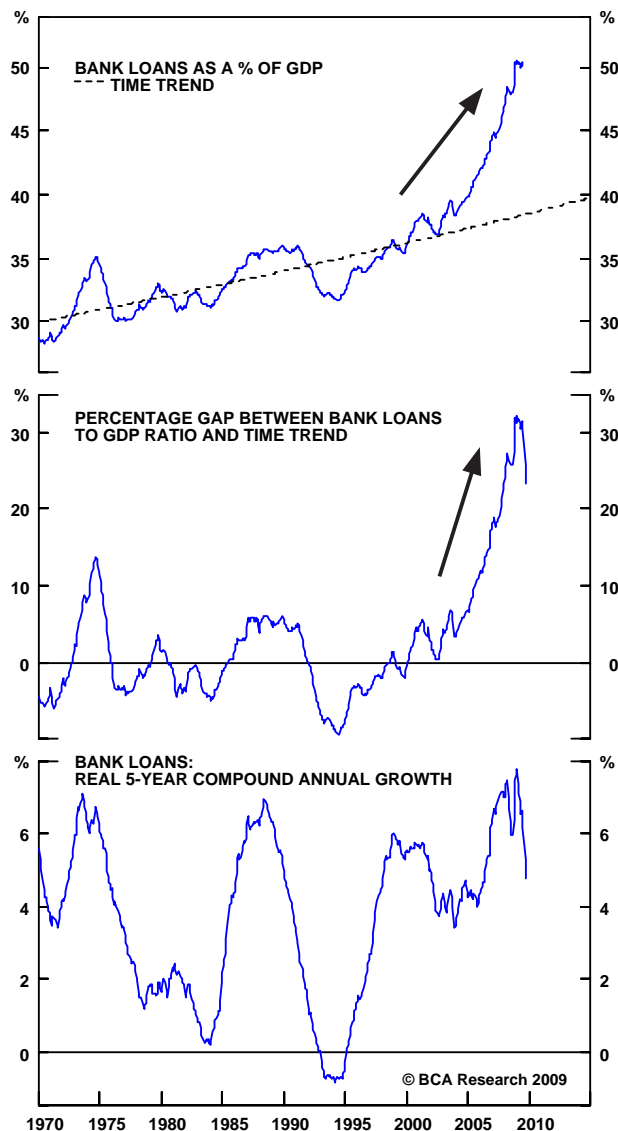
*President,
Boeckh Investments Inc.*

Similar to Martin Barnes' opening comments, Tony Boeckh expressed great uneasiness with the economic and financial outlook. The magnitude of stimulus is unprecedented. It is an experiment that has never been tried before and with unknown consequences. The Fed is obsessed with the Japan experience and will do anything to avoid that outcome for the U.S. However, the "Great Reflation" could wind up being the "Great Inflation". The avalanche of money has to find a home somewhere, and for now it is going into financial assets. However, the economic fundamentals eventually have to support the run up in asset prices in order for the bull market to continue.

Boeckh highlighted that the Fed can no longer ignore asset inflation when setting monetary policy. Balance sheets are being repaired by asset inflation, but there is a limit to how much is healthy. The Fed now has a credibility problem, thanks to former Fed Chairman Greenspan.

The global monetary system is one of the great villains behind the crisis according to Boeckh. The U.S. can run persistent balance of payments deficits. Money flows out of the U.S., but then flows back as

CHART 5
25-Year Credit Inflation



foreign investors buy U.S. assets. The system allowed the U.S. to have a 25-year credit inflation (Chart 5).

Mr. Boeckh believes that the asset inflation will not last long because the economy is not on solid ground. In particular, U.S. living standards will have to fall, largely via a decline in the U.S. dollar. The drop in living standards cannot be prevented by the Great Reflation. He believes that the ending will be painful. The decline in the dollar will be sustained and it will lose its reserve currency status. A major dollar crisis is likely in the next 3 to 5 years.

Russell Napier warned that investors will have to live with inflation, taxation and currency depreciation for the next two decades. He holds a bearish long-term view, which includes an eventual debt crisis due to the inability/unwillingness of Congress to deal with the demographic impact on the budget deficit. Nonetheless, he is cyclically bullish on the equity market at the moment for several reasons:

- Corporate earnings according to the NIPA data are better than the S&P 500 EPS figures suggest (the latter have been temporarily depressed by the massive write-offs). Profit margins have not fallen as much as one would have expected given the weakness in the economy (which is bullish as the economy revives; **Chart 6**).
- Banks are repairing themselves by buying government debt. Moreover, the government will be involved in the banking system for a long time, which effectively is a move towards a command economy. The government is in the capital allocation business through its controlling interest in the major banks, and will force an increase in the availability of credit.
- There will be an M&A boom; corporate cash flow is very high and will make many companies attractive takeover targets. Asian companies will be purchasing U.S. companies. The re-leveraging of the corporate sector will help to boost stock prices.

Napier believes that stocks are in a cyclical bull market, although this is highly dependent on his expectation of a positive surprise in private sector credit growth. The price to be paid for public debt issuance will be an eventual crisis in the Treasury market, although this could be many years away when demographic pressures reach critical levels.

Francis Scotland reviewed BCA's long-standing Debt Supercycle theme. He wondered if the Supercycle is over because the authorities no longer have the ability to stimulate demand using interest

CHART 6
Profit Margins Have Held Up

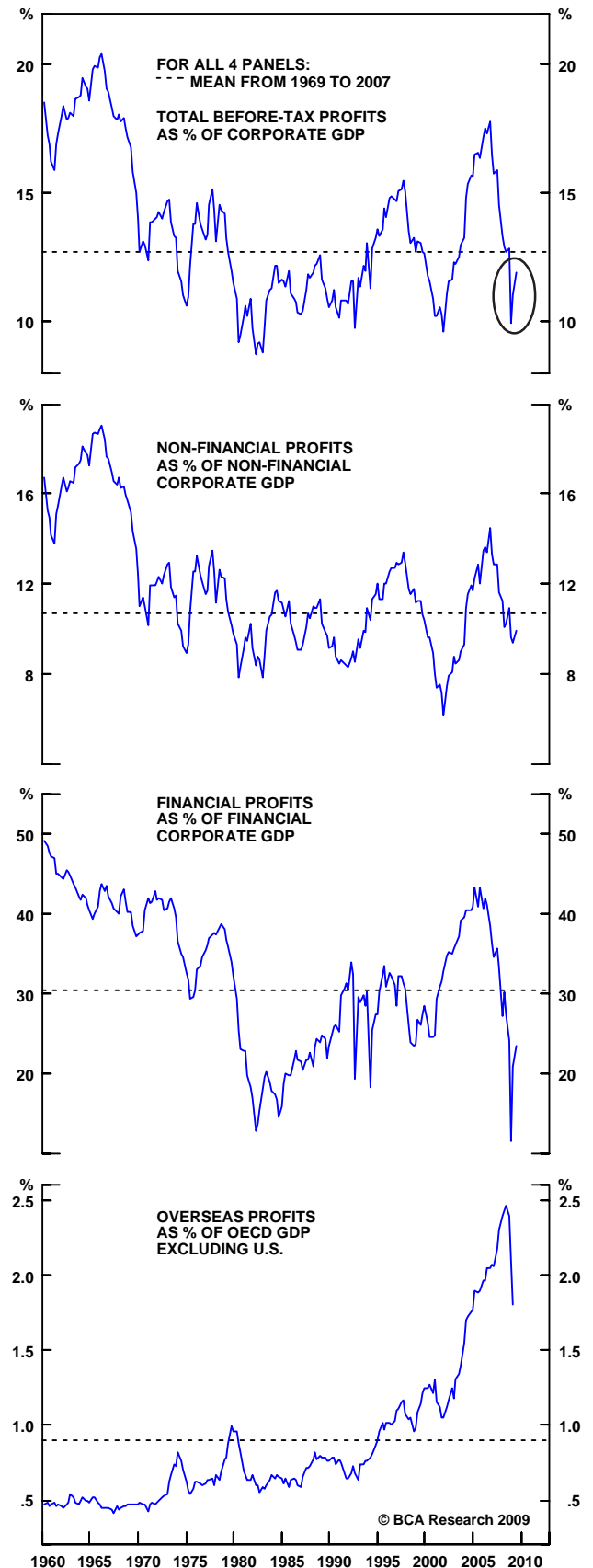
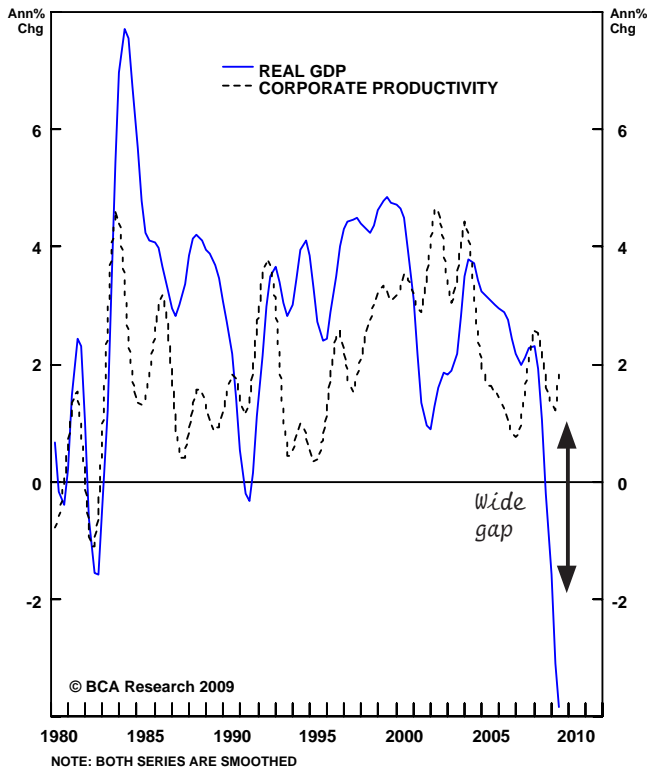


CHART 7
Productivity Has Been Impressive



rates. If so, then the outcome would be extremely deflationary.

Even if the Supercycle is not over, there is a seismic shift underway from the developed markets (the U.S. in particular) toward emerging economies. In the past, excess global production and savings were offset by U.S. overconsumption. However, the U.S. is no longer the buyer of last resort. President Obama was elected on a platform of wealth redistribution, not wealth creation (i.e. a big shift away from Reagan era). Re-regulation and taxes will weigh on U.S. growth at a time when capitalism is flourishing in the developing world. Former communist countries are now competing on lower taxes. Capital will migrate away from the U.S. and toward China, Taiwan and other developing countries.

The weakening U.S. dollar will cause more bubbles to form because countries will resist currency appreciation by keeping interest rates low. Mr. Scotland argued that eventually there will be a financing

crisis in the U.S. government debt market, which will precipitate a currency crisis. But the equity bull market will continue in the near term, driven by aggressive policy stimulus. The Fed is stacked with Depression experts who are fearful of tightening too early. However, it will be critical that investors know when to get out, because the bull market will end badly. The signal to reduce exposure is when the authorities feel good enough about the recovery to begin tightening policy.

Chen Zhao noted that global imbalances have been the dominant theme of the past 10-15 years, with abundant global savings offset by U.S. overconsumption. A resolution of this imbalance requires that China save less and spend more, while the U.S. saves and produces more. This theme will dictate relative trends in the global economy over the next decade. The implication is that U.S. growth will be weak and deleveraging will be ongoing.

A weaker U.S. dollar will be required to facilitate the deleveraging and rebalancing process. Corporate profits could also surprise on the upside as U.S. firms continue to focus on productivity gains (the latter have been impressive given the economic weakness; **Chart 7**). These two factors suggest that U.S. private savings will increase, helping to keep interest rates low for a long time.

Chen is bullish on the equity market because of policy stimulus, corporate productivity, low interest rates and a weakening dollar. However, he recommends buying some insurance in the form of gold, which could do well both in an inflationary and deflationary environment. In a world of competitive currency devaluation, gold will be the main beneficiary.

Follow Up Questions:

Is there no way for the U.S. dollar to rise?

■ **Napier:** Quantitative easing policies will reverse

when private sector credit growth begins to revive, which will occur in different countries at different times. The dollar could be temporarily strong next year because credit growth occurs in the U.S. first.

- **Scotland:** As the economy revives in 2010, the demand for dollars will increase. Be careful with bearish U.S. dollar positions next year.
- **Chen:** We could have a 20%-30% rise in the dollar in the next six months, as U.S. growth surprises on the upside. Such an increase would cause a sharp correction in the stock market.
- **Boeckh:** The only short-term bullish story for the dollar is a short-covering rally.

Could there be a multi-year equity bull market?

- **Boeckh:** No. Stock prices will fall when the policy stimulus fades.
- **Napier:** Stocks typically perform well until inflation reaches 4%, and it could take some time before inflation reaches that level again.

What could go wrong with emerging market stocks?

- **Scotland:** Not much. EM stocks could be the next bubble. Volatility will be very high, though.
- **Napier:** EM authorities will one day have to let their currencies rise when inflation becomes a problem. This could be a large blow to EM stocks and to the U.S. Treasury market.
- **Chen:** Investors have to discriminate between EM countries. They are not all the same and should not be lumped together.

What should investors buy over the next year?

- **Boeckh:** high quality companies with healthy balance sheets.
- **Napier:** U.S. bank stocks.
- **Scotland:** U.S. equities and the U.S. dollar.

- **Chen:** 70% stocks, 30% portfolio insurance (gold, government bonds and maybe the VIX).

The Implications of Record Policy Stimulus

Martin Feldstein

*George F. Baker Professor of Economics,
Harvard University*

John Makin

*Chief Economist and Principal,
Caxton Corporation*

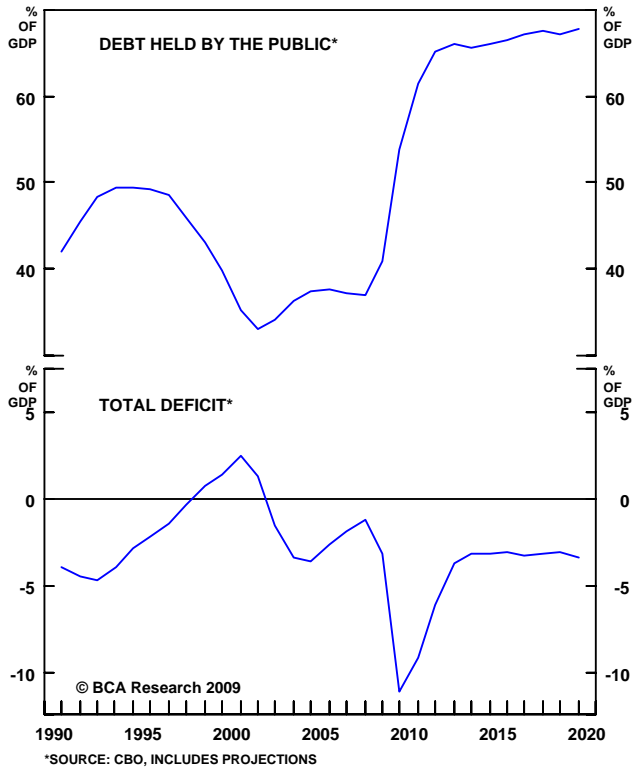
Rudolph Penner

*Senior Fellow holding Arjay and
Frances Miller Chair in Public Policy,
The Urban Institute*

Martin Feldstein noted that the Fed and most forecasters believe that the U.S. economy has entered a sustained recovery. However, the risk of a "double dip" is material in his view. The growth we are seeing now is being driven by temporary factors such as "cash for clunkers" and government tax credits for homebuyers. Consumer fundamentals are weak. The recovery will fade because fiscal stimulus will not last and monetary stimulus is not working. Also, small and medium sized-banks are cutting back on lending, in part due to the commercial real estate disaster, which would precipitate another economic downturn. Feldstein believes it is critical that regional banks obtain better access to credit and capital.

Mr. Feldstein worries about a loss of Fed independence, which could eventually cause turbulence in the bond market long before inflation accelerates. Political pressure on the Fed will be intense when it comes time to raise rates, and there are ways for Congress to "clip the Fed's wings". The long-term outlook for Treasuries is poor; investors should stay away. In contrast, inflation risk is much less in EMU because the ECB has more independence.

CHART 8
Who Will Buy All The Treasurys?



John Makin took a similarly sombre view when discussing the economic and financial outlook. We had a “near death experience” last year. The equity market has responded very positively to low interest rates and the fact that “we did not die”, but the economy will be slower to respond. Policy stimulus will provide real GDP growth of about 4% in the second half of 2009, but growth will drop back to 1% once the stimulus fades. Monetary policy is not stimulative at the moment because the money multiplier and velocity have collapsed. Net exports will not provide much support for the U.S. economy.

A downtrend in inflation will support the bond market, and a dollar meltdown is unlikely as long as inflation is benign. Makin pointed to Japan as supporting evidence for this view. The biggest risk to the outlook is that policy stimulus is withdrawn too early, as occurred in Japan and during the Great Depression in the U.S. However, if there is a double

dip, he worries that the size of the budget deficit will limit the ability of the authorities to respond with more stimulus. Mr. Makin argued that we currently underestimate the value of Treasurys as a store of wealth, and recommends buying them. He expects the 10-year Treasury yield will fall to 3%.

The major policy risk according to Makin is that policymakers tighten too early, possibly due to fears of higher inflation caused by rising commodity prices.

Rudy Penner argued that policy will make things worse, rather than better. He has never seen a situation before in which concerns about fiscal sustainability within Congress were so small. Lots of “pork” was implemented as part of the stimulus package. Penner wondered who will buy all the Treasurys that will be issued in the coming years. The major bond buyers (households, banks, foreign purchasers and the Fed) will have to increase their Treasury holdings by 100% over the next five years (Chart 8). How high will rates have to rise to make this happen? He recommends avoiding the Treasury bond market.

Mr. Penner claims that there will be little appetite among the Democrats to reduce the budget deficit as we approach the 2010 elections with an extremely high unemployment rate. There is unlikely to be another major stimulus package, but current stimulus policies could be extended (extra unemployment insurance benefits, home purchases tax credits, aid to States, etc). He does not believe that Washington will pass a substantial health care package without cheating (i.e. many gimmicks and hidden costs).

Mr. Penner agreed with other panelists at the conference that a crisis in the public finances will occur at some point. Soaring health care costs will require a substantial increase in taxes, including perhaps a VAT.

Mr. Feldstein and Makin assigned a 50% probability to the risk of a global equity market correction of more than 20%.

China's Evolving Role in the World

Geng Xiao

Director of Brookings Tsinghua Center for Public Policy at Tsinghua University and Senior Fellow of John L. Thornton China Center at Brookings Institution

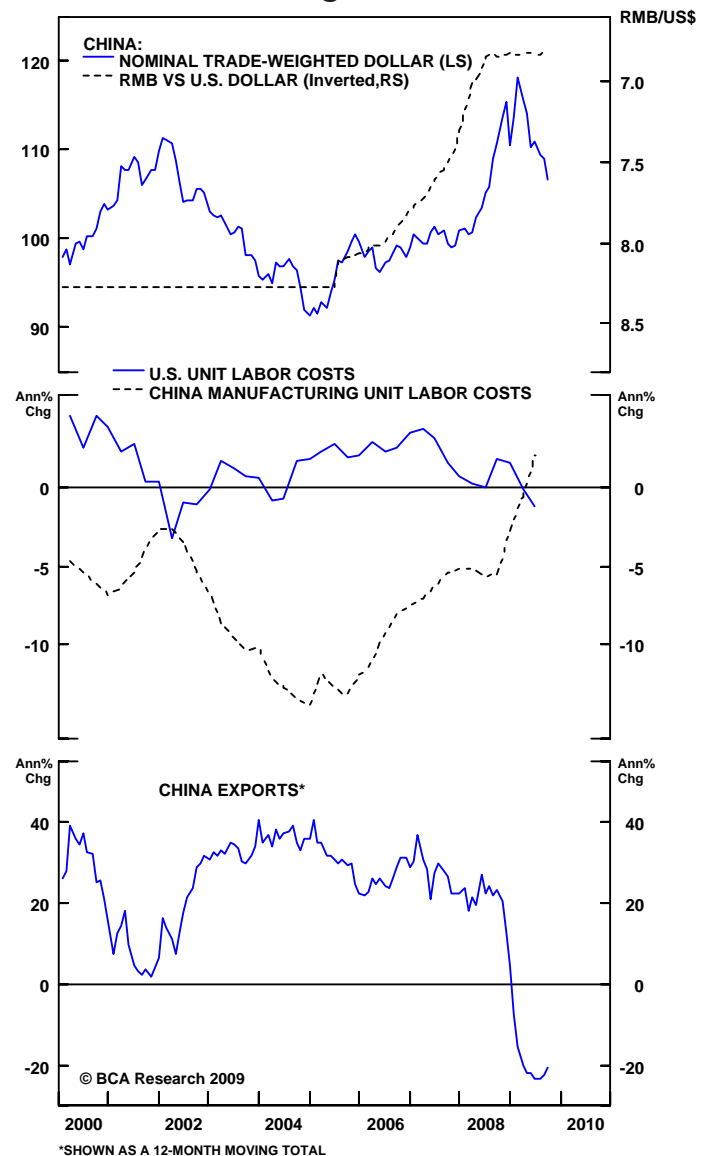
Yan Wang

Managing Editor,
BCA China Strategy

Geng Xiao began with a synopsis of the structural drivers of the Chinese economy: a large surplus of labor, the migration of rural workers to an urban setting and the consequent strong drag on individual earning power. China also has a surplus of capital. The surfeit of cheap labor and capital means there is fierce competition for investment and local governments are aggressive in providing low-cost land and lax at enforcing pollution rules in order to attract business. The end result is a surplus of cheap goods for export.

Xiao then argued that it was difficult to allow renminbi appreciation in nominal terms because of China's dependence on exports. Therefore, officials will only allow an appreciation in real terms. Specifically, he recommended a combination of fiscal expansion, offset by monetary contraction, i.e. raise rates but continue with efforts to expand credit, in a bid to create inflation. His goal would be to generate domestic price inflation in the range of 5-7%, much higher than in the U.S. The real RMB exchange rate needs to appreciate over time, but it is much better for China to achieve this via higher domestic inflation than through an appreciation of the RMB (**Chart 9**).

CHART 9
China: Real Exchange Rate Must Rise



Yan Wang noted that China cut reserve requirements and interest rates aggressively in response to the global crisis. As a result, the economy enjoyed a huge rebound in spending and capital investment. We are now at the end of the first stage of recovery. Growth is shifting from policy-driven to other macroeconomic factors. The first of these drivers will be exports, which collapsed after growing at a 20-30% pace in past few years. New evidence suggests that exports are about to recover. The second driver is consumer spending, which did

not slow much due to government incentives to buy cars and other consumer goods. Car sales are up 80% from last year.

Additional panelist comments on export growth, domestic investment, and foreign currency reserves:

Xiao: If China continues to get 30% growth in exports we will not get inflation, we will get deflation. Cheap money leads to a lot of wasteful investment, so China needs to raise the prices of land, water, and pollution abatement. Government officials must shift their focus from buying Treasury securities to reforming infrastructure rules. The key for China is investment; government ownership is wasteful – it must strive to improve efficiency of investment and the amount of investment.

Still, the regulatory structure and financial system pose constraints on spending. Chinese companies are efficient, but they are subsidized. The country is enjoying immense productivity gains due to building of infrastructure (subway, highway, airports).

Two-thirds of capital inflows represent hot money. If the PBoC does not sterilize, that is good news because it will generate inflation. China needs higher inflation, which is preferable to nominal currency appreciation.

Wang: The government is doing a lot to rebalance the economy – spurring consumer growth for example. Also, it is diversifying away from its dependence on the U.S. consumer by increasing sales to emerging markets. EM now accounts for more sales than the G7.

Capital spending is robust, but growth is also strong so it is difficult to measure whether investment is sufficient. China has adequate savings to fuel a high level of domestic investment. Also, there is no sign yet of diminishing returns to investment – the incremental capital output ratio is still quite high.

There are two sources of pressure on the renminbi: economic and political. The former is not a factor since core inflation is low. However, political pressure is mounting. Other countries are suffering weak growth, so of course China is under pressure to appreciate to help ease pressure.

Currencies And The Future Of The International Monetary System

Bernard Connolly

*Managing Director,
Connolly Global Macro Advisors Ltd.*

Marc Chandler

*Global Head of Currency Strategy,
Brown Brothers Harriman*

Harvinder Kalirai

*Managing Editor,
BCA Foreign Exchange Strategy*

Bernard Connolly highlighted that the outlook for currencies depends on which scenario we get for the U.S. economy: a renewed “bubble” or a non-bubble environment. A bubble environment is likely if the U.S. continues along the current path of socialization of the financial sector, a process Connolly refers to as the “Europization” of the U.S. In contrast, Mr. Connolly holds out hope that the U.S. will instead carve out a renewed entrepreneurial environment that “reinvigorates capitalism”, which would lead to a more sustainable growth trajectory.

In any case, the U.S. dollar must depreciate substantially in order to allow the U.S. to return to equilibrium according to Bernard; a decline of at least 25% is required, but this is not feasible on a 3-4 year horizon, at least not against the key benchmark currencies, such as the Chinese RMB or the euro.

Bernard also argued against the ascendancy of the euro, based on his view that Germany’s importance

as a driver of euro strength was waning in favor of weaker countries such as Spain.

Specific comments on currencies of other countries include:

- the fundamentals are bad for the Japanese yen;
- the British pound could have the most room to snap back given the enormity of its decline in 2008;
- the Swedish krona has latitude to recover, but will be held back in the short term by Sweden's exposure to Latvia;
- the Canadian dollar has scope to appreciate well past parity, but only in the bubble scenario, not in the non-bubble scenario.

Whereas the consensus in the room was clearly tilted in favor of dollar weakness, Marc Chandler unambiguously and fervently embraced the contrary opinion. He began by dismissing some of the usual arguments for a dollar decline – the desire by some foreign central banks to diversify their reserves, or the desire by some to denominate oil purchases in a basket of currencies – pointing out simply that these forces are not new, and have often coincided with periods when the dollar was appreciating (**Chart 10**).

He then proceeded to lay out the case for why the dollar could actually be one of the better performing currencies:

- The forex market is one of the most political markets in the world and the U.S. one of its most stable.
- Capital flows dwarf and are more important than trade flows.
- The rise of China comes not so much at the expense of the U.S., but more at the expense of other developing nations, as well as Japan. The U.S. manufacturing sector is still larger than that of all of the BRICs countries put together.

CHART 10
Diversification Is Not New

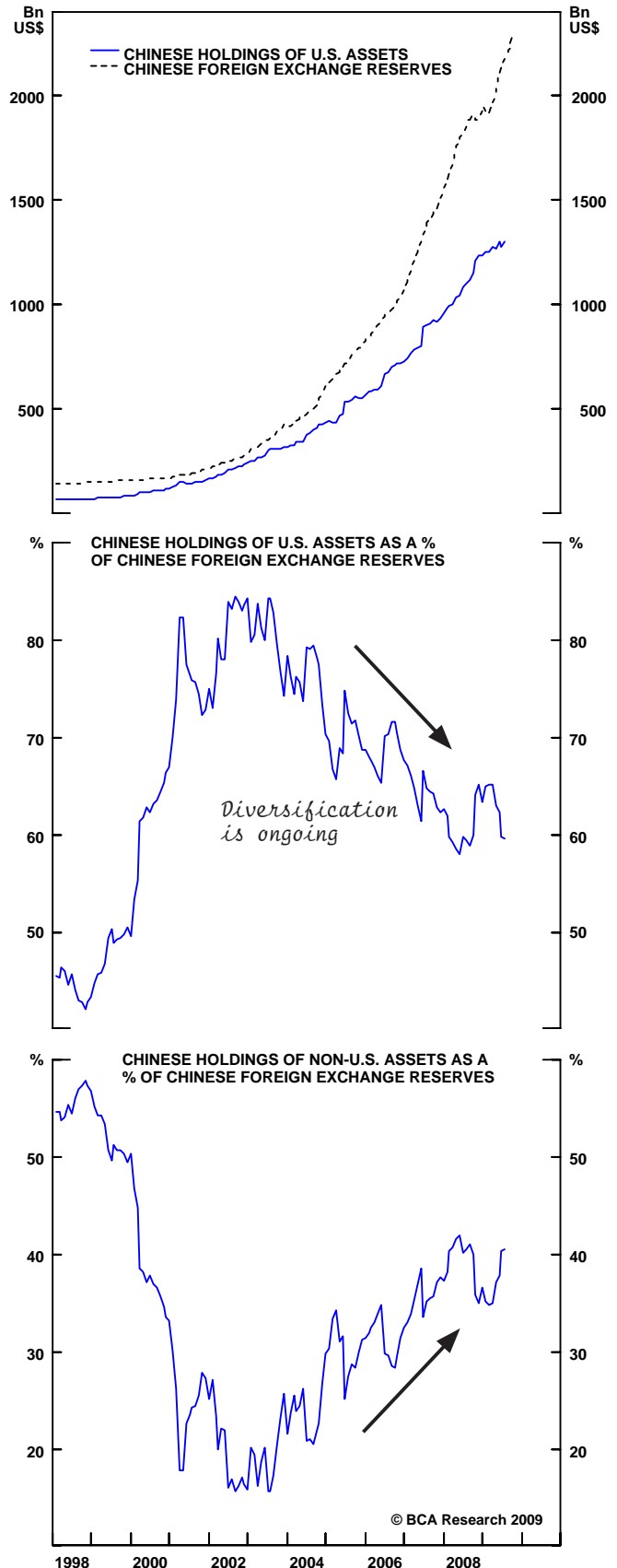
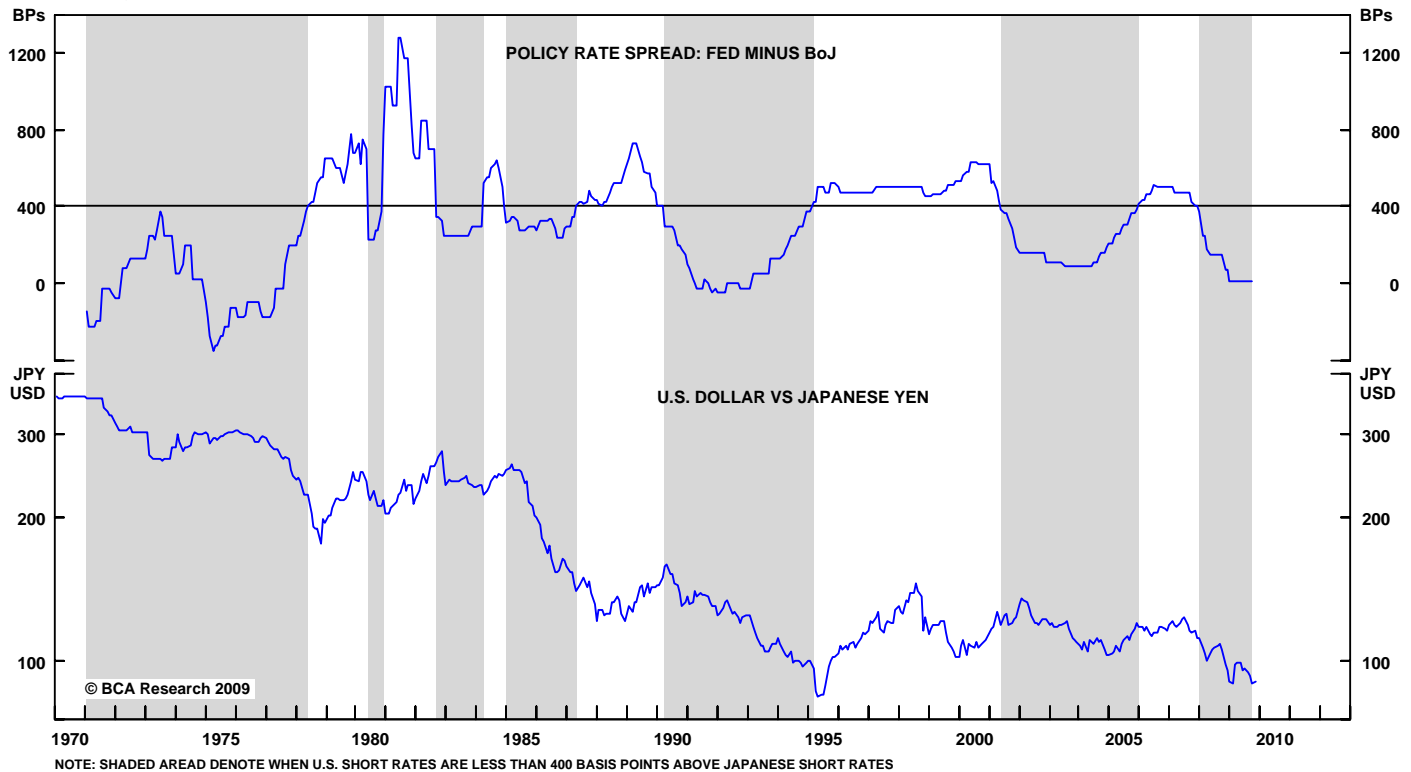


CHART 11
Policy Rate Differential Favors The Yen



- Recent weakness versus the Canadian and Australian dollars for example is not so much because of the commodity boom, but more because these countries have stronger banking sectors and support higher levels of the real interest rate.
- Demographics (birth rate) are relatively positive for the U.S. compared with other western nations as well as Japan and even China.
- The average American has 12.3 years of education, among the highest in the world, which is a strong predictor of productivity growth. This implies U.S. productivity growth will remain supportive of the dollar.

In short, Chandler believes that most investors underestimate or take for granted the strongly supportive structural influences on the dollar's value and instead place too much focus on shorter term

cyclical forces, which have exaggerated recent dollar movements.

BCA's Harvinder Kalirai began by pointing out a few dollar bearish points not covered by the other panelists, most notably its emerging role as the funding currency in the carry trade. He argued against a dollar crisis in the near term however, as Asian central banks continue to build reserves. And because of the inflexibility in Asian currencies (especially the renminbi), the euro was at risk of experiencing a severe overshoot. Similarly, commodity currencies should enjoy more upside due to rising terms of trade.

Kalirai was also more positive on the Japanese yen than either of the other speakers, noting that valuation yardsticks change over time. Although the yen peaked at 80 versus the dollar in 1995, he argued that it would have to reach 45 to be similarly

overvalued today. As long as the interest rate differential is less than 4%, there will be downward pressure on the dollar versus the yen (**Chart 11**). He does not believe that the U.S. policy rate can get back to 4% anytime soon. He also noted that a short US\$/¥ position made a good portfolio hedge against flare ups in risk aversion.

The panelists' picks for top performing currencies over the next year and the long term are as follows:

	2010	The Longer Term
Connolly	Bubble Scenario: C\$, A\$ Non-Bubble Scenario: CHF, Yen	Gold
Chandler	EM: eg. India, South Africa, Brazil	US\$
Kalirai	Commodity Currencies	Gold



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