

- **Currency:** One camp --- call it the **Nouriel Roubini** (a.k.a. Dr. Doom) camp --- argues that U.S. global economic dominance is over and we are now entering an Asian century dominated by **China** and its currency. The main argument: nations that have held the global reserve currency in the past have been net foreign creditors and lenders during their glory years. China fits that bill today and the US, with its massive trade and budget deficits, no longer does. The Chinese central bank governor, **Zhou Xiaochuan**, at the recent **G20** meeting in April, floated a trial balloon proposing a new global system under the auspices of the **International Monetary Fund**. Other than the **Russians**, no one signed up. The other (more moderate?) camp agrees that the world economic/ political order may be changing, but holds that meaningful changes are still a ways off, not something that investors need to worry about today. Overwhelmingly the US\$ is the reserve and transaction currency of choice. No other economy is large enough, or with deep and open enough capital markets. The euro might become an alternative down the road, but it remains too new and lacks the necessary underpinning of political cohesion. In the near term, a softer US\$ also serves to make US-based global companies more competitive.

- **Playing politics with currency:** Since the collapse of **Bretton Woods** in 1971, the global economy has tried to function with floating exchange rates, in which the market is said to set currency prices. Yet the market for currencies isn't that freely traded. Central banks control the supply of currencies through their monopoly on money creation, and their policies can have global repercussions. Nations also use currency devaluation for trade advantages. Since 2001 **China** has pegged its currency to the **US\$** at what is considered to be an artificially low rate, contributing in part to today's imbalances. **Mr. Zhou's** trial balloon is really a warning that reserve currency status carries global obligations and that the U.S. should not be tempted to debase its currency (by allowing inflation to rise) as a means of diluting its debt burden. Mr. Zhou proposed an international reserve currency "anchored to a stable benchmark and issued according to a clear set of rules ... disconnected from economic conditions and sovereign interests of any single country." In other words, China wants a '**Bretton Woods III**' system to mitigate US influence and to protect Chinese interests. The **US** and **China** are mirrored economies, and will likely develop a solution that cuts both ways because it is in their interest to manage such global issues for themselves.

- **A note about gold:** Given the level turmoil since November 2008, gold has done well but has not broken out and held above \$1000/ ounce suggesting that concerns over holding US assets are moderate. In fact the opposite seems to be true as the value of the US\$ has surged in times of greatest panic in the past six months.

-**Is the consumer missing? Brian Milner** (Saturday's **Globe and Mail**) opines that there may be many drivers pushing stock market valuations, but the US consumer isn't one of them. Mr. Milner then looks to **David Rosenberg** --- who has a "formidable reputation as an early and consistent bear" and recently joined Toronto manager **Gluskin Sheff** --- to supply the necessary facts and argument which are simple enough: US households have taken a "US\$20 trillion hit to their collective balance sheets" and as a result there will be "dramatic changes to savings and consumption habits that are likely to be deep and long lasting." This damage will only be corrected by a recovery in US housing without which an economic recovery is not sustainable. While neither Mr. Milner nor Mr. Rosenberg quantifies just what the housing recovery looks like, it apparently hasn't happened yet, isn't about to happen either, and therefore for the markets to rally now is premature. This is a common sense view --- declining car sales in the US are a good indicator of consumer retrenchment for example --- but other research (see our April 20th newsletter) indicates that the decline in house prices is not as widespread a phenomenon as one would think. In fact, there is no decline in housing prices in 34 of 50 states and consumer retrenchment is much more likely a sudden stop in spending by over-leveraged households in those regions where house prices did crash, and a fearful reaction to unfolding events by everyone else. In the same vein, while unemployment rates are rising (about 8.9%) and provide much negative feedback, the bulk of eligible Americans (+90%) are working and earning. Yet other research (see March 23rd and 31st) shows that housing is more affordable today (ironically in part because of easing credit) than at any other times since the 1970s and that all past housing recoveries started before unemployment rates peaked (that is, just about now). Undoubtedly, in absolute terms, consumers will continue to diet and buy fewer cars (and pay less for them), second properties, boats and other baubles for a while, and savings rates will increase, but that doesn't mean that the consumer is missing let alone lost or that the US economy is locked in neutral. For now to focus on the US consumer exclusively is also to neglect the impact of the US\$787 billion economic stimulus package: this is just being obstinately bearish. To be sure, there is uncertainty about the strength and speed of any recovery, but investor need to make investment decisions now, which means investing in something other than bonds. There is nothing in either Mr. Roubini's or Mr. Rosenberg's opinion that should preclude balanced and diversified investing in quality Canadian or US stocks.

-**TSX Composite suffers worst weekly drop since March 6:** that was the headline in the **Globe and Mail** on Saturday --- sounds awful. Yet it is also true that the **TSX** closed the week at 9,763 points, up 8.62% since January 1 but still off

some 35% on a year over year basis. The **S&P 500** is down 2.26% year to date and more than -40% year over year. By noon today (Tuesday, being the first trading day since the weekend) the **TSX** was at 10,092 or up 329 points or +3.38%, catching up with other markets which had surged the day before on no *real* news and even though the US economy continued to generate dispiriting statistics on Tuesday. These choppy waters may be fun for day traders (are there many left?) but are disconcerting for everyone else and it does signal an uncomfortable level of uncertainty in which case it is best to have a very diversified and balanced portfolio with an emphasis on quality (if it dips, it'll come back) and yield (to get paid to wait out the market) and ignore the day to day drama.

- **3X losers**: at exactly the point when you might want to tame the bear instinct, investors are indulging it. **Invesco Power Shares**, one of the largest Exchange Traded Fund (ETF) providers in the US publishes a monthly newsletter that, among other things, shows the top 10 ETFs with the highest net inflows. For the month of April, the list was topped by **Financial Bear 3X Shares (FAZ)**, with net inflows of US\$1.8 billion. This little bundle of joy allows investors to be 300% short (or very bearish) on the daily move of the **Russell Financial Services Index**. So, did it pay? If we assume that investors were filled at the average price for the month of \$10.38 per share, the investment is now worth approximately US\$800 million which only goes to prove that you don't have to be a big wheel on Wall Street or an institution like the **Caisse de depot** to vaporize US\$1 billion in a little over two weeks.

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