



THE ICEMAN COMETH

Ice was on my mind recently as I hacked away a thick layer of frozen H₂O on my windshield. I am referring here not just to the wintry white stuff, but also to financial “ice.” In recent years, some Wall Street strategists have waxed poetic about

“fire and ice” as major forces in financial markets, with “fire” referring to inflationary pressures heating up and “ice” referring to the opposite trend of deflation.

Since the U.S. Federal Reserve got nervous about the risk of deflation in 2002, many market participants have focused on “reflation trades,” which sought to benefit from the Fed’s efforts to flood the global monetary system with liquidity. Quite simply, the Fed put interest rates to emergency-low levels and let them stay low for an unusually long period. Here are a few of the results:

- The U.S. dollar dropped sharply;
- Raw industrial materials prices boomed;
- Energy prices soared;
- Commodity-related currencies rallied;
- Real estate prices soared;
- Emerging market stocks and bonds boomed;
- Small- and micro-cap stocks outperformed large caps;
- Stock and bond market volatility fell to extremely low levels.

In short, risky assets did very well in general, while the riskiest types of assets did extraordinarily well. Essentially, the Fed told market participants that it would underwrite aggressive risk taking. Market participants enthusiastically took the hint.

Even after the Fed started to raise rates in mid-2004, many of these reflation trades have continued to work well. The Fed’s slow and deliberate pace in moving rates up helped prolong the reflation-trade party, as did the fact that other central banks overseas kept interest rates low even as the Fed began to tighten. Global equity markets started the year on a strong note, with emerging markets leading the way. Many industrial commodity prices hit new highs as well.

Should We Care About the Icelandic Krona?

What prompted me to think about “ice” again was a recent page 42 story about the Icelandic krona. Toward the end of February, one of the international debt rating agencies became concerned about tiny Iceland’s not-so-tiny current account deficit. As a result, the agency downgraded the nation’s debt, which triggered a one-day drop in the value of the krona of 10%.

So what does that have to do with the price of tea in China? The short answer is more than you might think.

The longer answer is this: As economic historians have noted, what happens at the periphery of the world economy and financial markets can have surprisingly important implications for what happens later in the major core markets. The reason is that small markets sometimes function like the proverbial “canary in the coal mine” that keels over when the air goes bad.



In my opinion, the Icelandic saga suggests that the day in the sun for reflation trades may be over – or at least that twilight is rapidly approaching. Specifically, the plunge in the krona appears to reflect an intensifying liquidity squeeze across many markets – especially those that have benefited the most from extremely ample liquidity provided by the central banks.

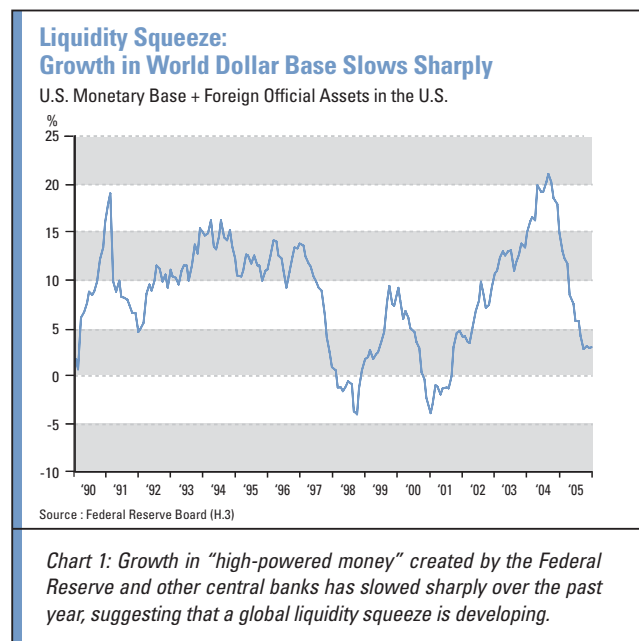
Here's why. When interest rates are extremely low and expected to stay relatively low, many financial market participants find themselves unable to resist the siren song of the so-called "carry trade." That means borrowing at a low rate in a currency like the dollar, the yen or the euro and then lending money in other countries with higher rates. When borrowing rates are low and stay low, small interest rate differentials can be magnified into large returns thanks to the liberal use of financial leverage.

Iceland is a prime example of a country that attracted the attention of the carry trade crowd since it has offered 10% rates to entice foreigners to finance its large current account deficit. As long as rates remained low elsewhere, Iceland's

markets were flooded with foreign money seeking to take advantage of its higher interest rates.

The challenge comes when interest rates elsewhere begin to rise and the growth of liquidity begins to slow. At that point, carry trades can become quite risky. One piece of bad news – like the Icelandic debt downgrade – can cause speculators to head for the exit all at the same time, resulting in huge price currency and bond yield movements amid panic selling.

As the *Financial Times* reported, "For traders who had borrowed in euros, the krona's sharp slide wiped out more than a year's worth of carry trade profits in one fell swoop." More interestingly, the *Financial Times* went on to note that, "These very same speculators, many of them hedge funds, will have built long positions in a plethora of other high-yielding currencies as well ... (so that) positions in one country were closed to fund losses in another, prompting further losses." That explained why other carry trade currencies like the South African rand, the Brazilian real and the New Zealand dollar also suffered sharp declines in sympathy with the krona.



Tracking the World Dollar Base

The connection to the price of tea in China – and the prices of many other commodities – comes from the fact that the Fed's monetary policy has tended to be a good leading indicator of commodity prices. The impact of Fed actions may take quite a bit of time – perhaps as long as two years – to show up in real world markets. But investors who casually dismiss the significance of the Fed's policy moves often end up wishing they had paid more attention.

In the spirit of "one picture is worth a thousand words," I will offer several pictures indicating that a sea change in the global liquidity environment is now underway. Consider Chart 1, which shows the growth rate of the "world dollar

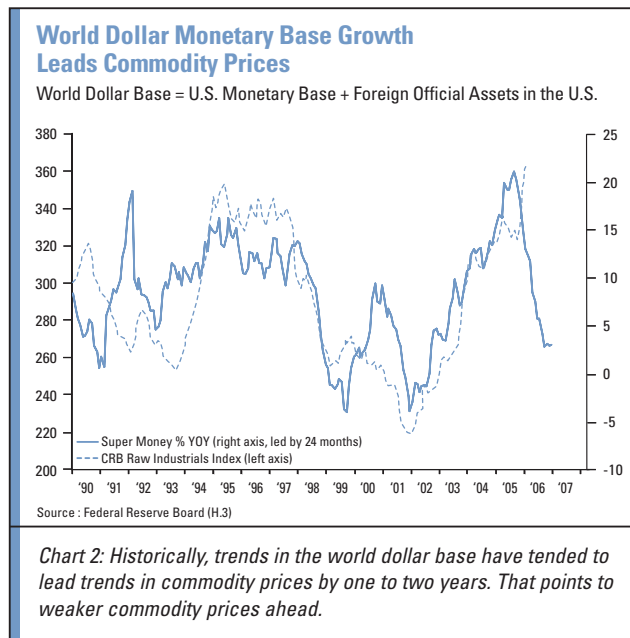
base.” This refers to the sum of the U.S. monetary base – which is basically the “high-powered money” created by the Fed at the electronic stroke of a pen – and the holdings of U.S. Treasury obligations by foreign central banks. Foreign central bank holdings of U.S. Treasuries are included because they reflect the creation of high-powered money overseas. That happens when major exporters like China and Japan try to prevent their currencies from rising by purchasing U.S. Treasuries. In doing so, they sell yuan or yen to buy dollars – and effectively inject large amounts of yuan and yen into their banking systems in the process. As recently as August 2004, the world’s dollar base by this measure was growing at an annual rate of 21%. This meant that the global financial system was virtually flooded with high-powered money that continues to slosh around the world today. It also meant that banks around the world were flush with reserves and eager to lend to all comers, including businesses in Beijing, China, hedge funds in Greenwich, Connecticut, and real estate speculators everywhere.

As Fed policy gradually tightened in 2005, the picture changed dramatically. By the end of 2005, the growth of the world’s dollar base slowed to only 3%. Further tightening by the Fed from this point could easily cause this measure to contract. An outright contraction of the global dollar base has typically preceded global growth slowdowns and, in some cases, ushered in financial fireworks like the Russian debt crisis of 1998.

The fact that the European Central Bank has entered into a monetary tightening phase and that the Bank of Japan is now preparing the markets for its own change in direction are clear evidence that the global monetary environment is entering a very different phase. And Iceland’s mini-crisis shows that this is beginning to matter in the real world.

What Will it Mean for Commodity Prices?

Now consider Chart 2, which once again shows the growth rate of the world money base, but in this case moved



forward by 24 months. This graphical sleight of hand shows that commodity prices historically have experienced major changes in direction one to two years after growth in the world dollar base changes course.

Since growth in the world dollar base peaked in August 2004 and has markedly decelerated since then, it would not be surprising to see broad-based weakness in commodity prices start in the second half of this year and continue well into 2007. That would be consistent with past business cycles following periods of Fed tightening.

How could all this unfold? Start with the U.S. housing market, which is showing distinct signs of weakening. If housing prices stagnate, consumer spending may slow sharply as consumers are no longer able to use their homes as ATM machines for withdrawing equity. A slowdown in U.S. consumer spending could then begin to affect China, where rising inventories of unsold goods would prompt a sharp slowing in Chinese industrial production. That, in turn, would slow China’s capital spending and thereby reduce the demand for commodities from one of the major new players in commodity markets.

Rising Real Rates Point to Higher Stock Market Volatility Ahead

VIX Index vs Real Fed Funds Rate

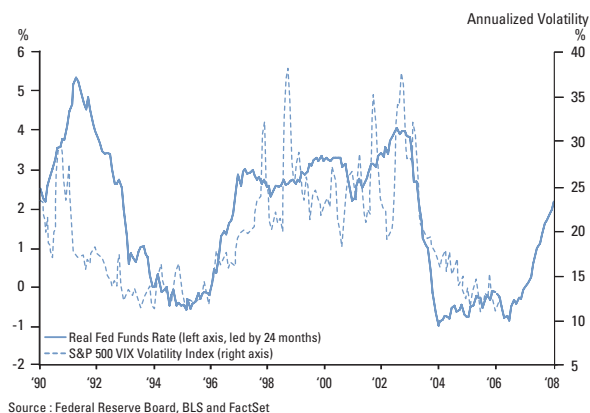


Chart 3: Historically, stock market volatility has declined following a drop in real rates – and vice versa. The recent rise in U.S. real interest rates points to higher stock volatility ahead.

Market Volatility Set to Rise?

What is true for commodity prices could well be true for many of the other financial asset classes that have benefited from reflation trades, including commodity-related currencies, emerging market stocks and bonds, and micro- and small-cap stocks. All of these asset classes have benefited not only from low interest rates and ample global liquidity, but also from the remarkably low stock market volatility that has encouraged investors to take risks. But that, too, seems likely to change in response to rising interest rates.

Consider Chart 3, which shows the historical relationship between U.S. real interest rates and the S&P VIX Index of overall market volatility, with the real interest rates line shifted ahead by 24 months. This shows that real interest rates are a good leading indicator of overall market volatility. When real rates go down, volatility tends to decline over the next several years, and vice versa. With real interest rates having been on the rise since mid-2004, history suggests that market volatility could begin to pick up in 2006. In other words, what happened in Iceland may not be an isolated incident.

Does this mean that a repeat of the 2000-2003 bear market is in the cards? We think not, mainly because stock market valuations are not as unfavourable as they were in late 1999 or early 2000. At that time, comparisons of stock market and bond market valuations like the Fed model suggested that stocks were more than 50% overvalued relative to bonds in the U.S. Now, in contrast, the Fed model suggests that stocks remain more than 30% undervalued relative to bonds.

However, there is no doubt that the environment could become more challenging – and volatile – as the Fed and other central banks continue to tighten policy, especially if the Fed raises rates above the 5% level the markets now see as its likely stopping point.

In response to these concerns, we have not made abrupt changes in our portfolios. But in recent months, our analysts have generally found less compelling upside potential relative to downside risk in commodity-related sectors, including energy and emerging markets. We have also increasingly favoured equities of large firms whose growth prospects seem more assured than those of more richly valued small- and mid-sized competitors that have benefited from global reflation.

In short, we doubt that this is the time to be chasing red-hot securities in risky companies and countries.

The Iceman Cometh – and his name is Ben Bernanke.

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