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Question:

AS THE U.S. ECONOMY CONTINUES TO RETRACT,
WHAT IS ONE'S BEST COURSE OF ACTION ?

Answer:

KEEP THE CASH IN RENMINBI AND STICK WITH ASIA

The economy of the United States of America is continuing to struggle and, by the looks of things, the situation is almost certain to deteriorate even further in the months to come.

Yet, the key indices of the US equity markets, from time to time, appear to be going from strength to strength.

One is told that the bottom on the bear market is in sight.

For anybody, endowed with the faculty of reason, this hypothesis seems impossible to digest as one US bank after another sacks hundreds of staff members while, at UBS AG, the Number One bank of Switzerland, one is told that many of the staff are just walking off the job.

Last Tuesday, UBS AG announced that, for the quarter, ended June 30, 2008, it had logged in a Loss Attributable to Shareholders of about $US329 million (about $HK2.57 billion), and, in addition, had written down about $US5.10 billion (about $HK39.78 billion) in respect of its exposure to the assets that it assumed in the subprime, mortgage-lending industry *'feeding frenzy'*, just a year or so ago.

A senior official at this internationally acclaimed bank (not named, it was noted by **TARGET** []), went on record as stating:

> *'The positive sentiment, seen at the end of the first quarter of 2008, that the credit crisis may be easing was short-lived, as trading conditions deteriorated significantly in the second half of May.'*

Up until last Tuesday, UBS AG had acknowledged that it had written down the value of its assets by not less than $US36.70 billion (about $HK286.26 billion).

Obviously, that figure has, now, to be increased by another $US5.10 billion, today.

The **I**nternational **M**onetary **F**und (**IMF**), recently, went on record as stating:

a. The US housing crisis will worsen;

b. The international credit crisis will worsen; and,

c. The US economy will underperform right into the middle of 2009.

And, yet, the Dow Jones Industrial Average rises, the Composite Index of The NASDAQ rises, and many Wall Street gurus claim that everything is hunky-dory.

Further, these Wall Street gurus are advocating that it is time to get fully invested.

What absolute rubbish!

With the US housing market, still in the doldrums, it is fully expected that it will take a number of years for the backlog of inventory of homes to be depleted.

In order for a US household to buy a new home or upgrade its existent home, that household needs to be assured of a steady source of income in order to meet debt service and reduce the household's financial commitment to the bank/finance house.

The chief breadwinner must be gainfully employed with the knowledge that the source of income will not dry up.

In today's US, many households are not certain just how long the breadwinners' monthly pay cheques will continue: Their jobs could vanish in a very short space of time in the same manner as the jobs at the fourth-largest, US bank, Wachovia Corporation, announced that it would be sacking 11,350 of its employees.

That announcement came only last Monday.

The IMF has gone on record, also, as stating that economic growth projections for the largest, single economy of the world are about 1.30 percent for 2008.

For 2009, the IMF is looking for growth of about 0.80 percent – only.

Not exactly recession, as a number of Wall Street gurus have been pronouncing, publicly, for the past few months, but, nevertheless, a sick-looking US economy, relative to that which the world had become accustomed in days of yore.

To add to the problems, there will be a new US Government Administration come this November.

That is another unknown coefficient to be factored into one's formula about the outlook for the US economy for the next 18 months or so.

<u>The Inflation Factor</u>

The US is spending more than it is earning.

This is, usually, called inflation.

The US Federal Reserve cannot, it appears, permit inflation to eat away at the very fabric of the US economy for very long and, probably, sooner rather than later, The Fed will be forced to raise interest rates in spite of everything – the US housing crisis, the credit crisis, etc, etc, etc.

This is similar to the conundrum that many very obese people face:

1. Suffer what is considered the terrible regimen of consuming only 1,500 calories per day with puffing and panting at least one hour of aerobics, daily; or,
2. Take the chance of dying of medical complications, caused by the effects of being terribly overweight.

Then, there is the current strength of the US dollar vis-à-vis other *'hard'* currencies of the world.

The immediate effect of a material increase in the translation value of the US dollar against, say, the euro, the British pound and/or the Japanese yen, is to make it more difficult for US industry to export its finished products because, in terms of the currencies of its main markets, the cost of US-produced goods will be seen to have risen, relative to the increase in the translation value of the greenback.

The US dollar is, without question, overvalued and its recent upward movement appears to be contrary to fundamentals with regard to the economy of the country.

As the US economy falls further and further into the economic abyss, so pressure will come to bear on its currency.

The dethronement of the US dollar as the world's premier currency is not on the cards, at least, not at this juncture, but its current translation level, on the world stage, appears untenable – and that has been the situation for a very long period of time.

On August 5, 2008, The Fed announced that it was keeping the Federal Funds Rate unchanged at 2 percent.

In its published determination, The Fed, also, said:

> *'Economic activity expanded in the second quarter, partly reflecting growth in consumer spending and exports. However, labor markets have softened further and financial markets remain under considerable stress. Tight credit conditions, the ongoing housing contraction, and elevated energy prices are likely to weigh on economic growth over the next few quarters. Over time, the substantial easing of monetary policy, combined with ongoing measures to foster market liquidity, should help to promote moderate economic growth.*
>
> *'Inflation has been high, spurred by the earlier increases in the prices of energy and some other commodities, and some indicators of inflation expectations have been elevated. The Committee expects inflation to moderate later this year and next year, but the inflation outlook remains highly uncertain.*
>
> *'Although downside risks to growth remain, the upside risks to inflation are also of significant concern to the Committee. The Committee will continue to monitor economic and financial developments and will act as needed to promote sustainable economic growth and price stability.'*

One does not have to be a Milton Friedman to understand the meaning behind the above, carefully crafted statement of The Fed.

Then, last Tuesday, Mr Richard Fisher, the President of Dallas Federal Reserve Bank, said that he saw the US economy, going through a period of slow growth and, before the year is out, it is quite likely that the economy could shrink, further.

While the US economy may well retract and is quite likely so to do, it does not mean that inflation will abate.

Far from it, in fact.

It would be myopic only to blame high food and high energy prices as the principle reasons for inflationary flames, licking the economies of the West.

Core inflation – sans food and energy prices – has climbed a percentage point of late, indicating, inter alia, that the broad price level is increasing as well.

High money growth is a contributing factor to inflation.

The monetary policies of Asia have been, and continue to be, one of the problems, leading to inflation in the most-populous part of the world.

In the People's Republic of China (PRC), this has already, obliquely, been accepted, and steps are being taken, today, to rein in inflation in the country.

Last Tuesday, The National Bureau of Statistics of the Government of the PRC announced the Consumer Price Index for July rose about 6.30 percent, down about 11.27 percentile points, compared with the June statistic, and down about 18.18 percentile points, compared with May's statistic.

For many months, now, the Government of the PRC has been stating, on numerous occasions, that it would tackle the problem of inflation.

It appears to have succeeded.

Many economists, however, still maintain that the monetary policy of the PRC continues to be much too loose.

When the economy of the PRC was running down the economic track at full speed, credit growth was accelerating at historical highs while, at the same time, the labour markets were tightening at a very fast pace.

Which one would expect of the fastest-growing economy of the world, especially one where the vast majority of its population has been *'starved'* of such items, taken for granted in the West, as motor cars, television sets, refrigerators, washing machines, etc, etc, etc, as well as luxury items, made in the West, for the past half a century or so.

The People's Bank of China, which is the Central Bank of the PRC, kept interest rates, in real terms, next to zero.

Money was flowing and people were paying for goods with cash.

In an off-the-cuff interview with Ms Jenny Zheng (), General Manager, Greater China (), Rolls-Royce Motor Cars Ltd, **TARGET** was told that, in the PRC, there was no question of obtaining credit from banks in order to pay for a new Rolls-Royce, costing upwards of $HK7 million, because … *'They* (new customers) *just pay with cash!'*

At many shops, selling luxury items in the Hongkong Special Administrative Region (HKSAR) of the PRC, electrically operated money counters have been installed so that, when a customer from, say, Shanghai, Beijing or Shenzhen, comes to buy something which costs upwards of 6 digits, the money counting machine does the calculations of the paper money because of the time element, involved in tabulating the many hundreds of $HK100 bills, used to pay for the luxury item(s).

The PRC has amassed massive, record-setting current account surpluses and has accumulated trillions of US dollars' worth of foreign exchange reserves.

This continues to fuel the money supply in the country.

The economy will continue to power away albeit at a slightly slower pace than, say, 2 years ago.

Thus, inflation will continue to plague the country – even if commodity prices abate.

But the recent history of the PRC has indicated that the powers-that-be in Beijing are well aware of the horrors of galloping inflation and will take the necessary action when and where required in order to keep the economy in check – without killing off the geese, laying the golden eggs.

<u>Conclusion</u>: Stick with Asia; and, keeping the cash in renminbi will pay big dividends in the years to follow.

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