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## Dialing for dollars

### *APEC frets, stocks rally on US dollar weakness*

November 13, 2009 – Warren Buffett, the renowned CEO of Berkshire Hathaway Inc., believes that the recession is over and that markets have bottomed. “The financial panic is behind us,” he said in comments to students at the Columbia Business School of Columbia University in New York. He also added a throwaway line about the markets. “The bottom has come in stocks,” he said. “Don’t pass on something that’s attractive today.” And he added, “The worst investment you can have is cash.” Anyone who’s watched from the sidelines, garbed in a risk-free cloak of cash, as global equity markets surge 50%, 60%, 70% since March, would have to agree.



As we described in our notes last week, Mr. Buffett is putting his money where his mouth is. A couple of weeks ago Berkshire made a bid for the stock of railroad Burlington Northern Sante Fe Inc. that it didn’t already own.



Mr. Buffett is right to be bullish on the stock market. Indeed, he could safely be bullish on most any market at the moment, because, unusually, almost every market has been rising concurrently. Stocks, bonds, and commodities have been rallying in synch for much of the year. Take a look at the accompanying graphs of three broad US iShares global exchange traded funds representing commodities (GSG), Treasuries (IGOV), and stocks (ACWI).

There’s only one thing that explains the highly correlated global surge in asset prices through 2009, and that’s the

extraordinary tide of easy money unleashed on global financial markets by nervous central banks seeking to avoid a deeper financial and economic crisis.



Interest rates near zero, central bank asset purchases, “quantitative easing,” and all the rest are really just ways to create money out of thin air. But easy money is a cunning genie. Yes, it can grant you three wishes, provided they are carefully worded. But once let out of the bottle, it’s exceedingly difficult to entice it back in.

The price of gold has climbed to more than US\$1,100 in response. Equity and

real estate in Asia has approached bubble territory. The US dollar remains weak against the euro, the Canadian dollar, and most every other currency in the world. Indeed, the greenback remains near 15-month lows against a basket of currencies, causing more than a little consternation at last week’s Asia-Pacific Economic Cooperation (APEC) summit in Singapore.

Once again, the APEC finance ministers called on US Treasury Secretary Timothy Geithner to do *something* to strengthen the US dollar. And he did: He reiterated the US government’s support for a strong dollar. But talk is cheap, and getting increasingly cheaper, given the generally negative outlook for the greenback.

The APEC ministers’ concerns are understandable, and are reflected somewhat here in Canada. A weak US dollar means their currencies are relatively stronger, which puts a real drag on their export-dependent economies. Several Asian nations have been buying up US dollars in an attempt to stem the greenback’s slide and stabilize their own currencies. But that’s only a stop-gap.

Pressure has increased on China as well to let the yuan appreciate against the US dollar, something the Chinese are hugely reluctant to do, as the year-over-year decline in Chinese exports is beginning to ease. Exports fell 13.8% in October from a year earlier, the smallest drop in 10 months. Climbing third-quarter industrial output, retail sales, and labor demand all point to a continuing strong rebound in China’s economic growth after posting 8.9% GDP expansion in the third quarter. It’s no wonder the Chinese central bank is reluctant to tinker with monetary policy at this point.

European governments are also anxious about the relative strength of the euro against the US dollar. Especially now that the first fragile hints of recovery are starting to show. The 27-country European Union, which includes the 16-country euro zone, posted 0.2% GDP growth in the third quarter. Eurozone GDP rose 0.4%. The numbers are at least barely positive, backed by 3.5% growth in Germany’s industrial production in the third quarter. Germany accounts for 30% of the eurozone’s GDP, and is the engine of growth for the

entire region. Continued euro strength, however, could suppress the strength of recovery next year. Hence the European governments' concerns about the ailing greenback.

So far, at least, the US government has done nothing more than pay lip service to its "commitment" to a strong dollar. That's understandable, too, as a relatively weaker greenback lends some support to the domestic US economy. The US trade deficit widened in September, but the trade balance overall is still better than it was a year ago. American consumers spent a bit more in the third quarter, on things like cars and gas, driving import growth up 5.8% in September. And the export side of the trade equation climbed for the fifth straight month in September, albeit more slowly, at 2.9%. Still, it's indicative of a revival in the export sector, a revival that continues to rely on the relative weakness of the greenback.

As long as domestic inflation remains a non-issue, don't expect to see the US actually do anything about the weakness of the dollar for the time being. Unfortunately, that implies more pain for export-dependent and commodity currencies, including Canada's loonie, which is likely to reach for parity in the next month or two. But it also implies a widening US trade deficit and increased risk of asset bubbles and rising volatility in commodities. Right now, though, those are not of any concern to the US Federal Reserve.

Stock markets have taken all this in stride, continuing to rally for the second consecutive week. The S&P/TSX Composite Index rose 1.4% on the week, while the S&P 500 Composite Index advanced 2.6% and the Dow Jones Industrial Average gained 2.5%.

The big question is whether the current above-average S&P 500 valuation at 17 times forward operating earnings is justified. If you believe Warren Buffett, the answer is that not only is it justified, it's headed higher. ■

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