

## Growing volatility

### *Markets retreat on Dubai debt default*

*November 27, 2009* – Stock markets retreated somewhat last week, as the Persian Gulf Emirate of Dubai sought a six-month moratorium on debt repayments by its main corporate investment agency, Dubai World. The Emirate’s *de facto* default on some US\$60 billion in sovereign debt follows similar troubles at two large family-run conglomerates in Saudi Arabia earlier this year, involving about US\$15 billion and 100 creditors. Dubai, of course, is best known as home to the world’s tallest building and an artificial palm-tree shaped island, both expansive projects implemented at the peak of the oil boom before the 2008 financial crisis. Now it may become better known as the first domino to fall in the next phase of the financial crisis that began with the collapse of investment bank Lehman Bros. in 2008.

According to some estimates, Dubai’s debt may exceed US\$90 billion. Its biggest creditors are other Emirates banks and institutions. But investors spent much of last week poring over the financials of major European banks that also hold large wads of Dubai debt. These include the still very shaky Royal Bank of Scotland Group Plc, as well as HSBC Holdings, Barclay’s Plc, and Lloyd’s Banking Group Plc.

Even as markets tumbled on the news, the cost of insuring Dubai’s debt through credit default swaps rose 50%, also pushing up insurance costs for the debt of other fragile sovereigns, including Russia, Greece, Turkey, Ireland, Bahrain, and Qatar. The buzzword in the econo-sphere for this two-pronged phenomenon of falling markets and rising insurance is “risk-aversion.” And like all buzzwords, it uses multiple words of two or more syllables, when one will do very nicely: “fear.”

Dubai’s debt troubles are just one strand in the rapidly developing second phase of the global financial crisis. This phase involves not only the rebalancing of emerging market currencies but also another round of deleveraging, especially in emerging market economies, where excessive borrowing at low rates simply cannot be “bailed out” by taxpayers as it has been in the industrialized world.

Last week, Vietnam devalued its currency by another 5%, following two previous devaluations since June 2008. It’s another symptom of the troubles roiling currency markets in the developing world, as heavily export-dependent countries attempt to retain a competitive advantage by keeping its currency from appreciating against the Chinese

yuan – its (and most of Asia’s) biggest rival in export markets. But export concerns are not the only factor pressuring up Vietnamese and other currencies.

Russia, for example, is also attempting to control the value of the rouble, which has been driven up by flows of hot money into Russian stocks, seeking to profit from the so-called “carry trade” against the US dollar – a process by which traders borrow in a cheaper currency (the US dollar, at the moment) and invest in money markets that offer much higher yields. Vietnam, Taiwan, Brazil, and others share the same problem. But their problem is not cabals of “speculators” or other dark conspiracies.

Russia’s attempts to blame “short-term speculative capital” and to control markets is likely destined to fail, as are Vietnam’s and others’ attempts to contain currency appreciation through devaluation. The problem will persist for as long as the US dollar remains weak and US interest rates remain near zero.

US dollar weakness is not only the prime incentive behind the hot money flows of the international carry trade, it’s also the fuel for the commodities boom that has seen price surge in recent months. Gold, especially, has benefited, as its price rose to a record high last week, touching US\$1,188 per ounce. The weak US dollar has been the main driver for gold, but more recently we suspect that gold’s attribute as a crisis hedge has been adding to its popularity.

As the ultimate hard store of value, gold has no rival. And a number of central banks in the developing world make no bones about subscribing to that philosophy. As reported last week, India purchased 200 tonnes of the stuff recently through an auction conducted by the International Monetary Fund. Sri Lanka purchased 10 tonnes, and tiny Mauritius bought 2 tonnes. The IMF authorized the sale of 403.3 tonnes from its 3,000-tonne horde, and it remains to be seen which other central banks will quietly put some more gold in their vaults to diversify their reserves and hedge against growing currency market volatility and a potential currency cascade of the kind that rocked Asia and Latin America over the past two decades.

One such imbroglio, now long forgotten in all the more recent excitement, was the collapse and bailout of trillion-dollar US hedge fund Long-Term Capital Management (LTCM) in 1998. Led by Nobel-prize winning economists no less, LTCM was blindsided by a default in (wait for it) Russian government bonds. It all sounds depressingly familiar.

And that’s the main reason why markets retreated last week, despite some economic data showing still more signs of a return to growth. US consumer spending and personal income both rose in October, while jobless claims fell and new-home sales spiked 6.2%. Corporate profits also surged 11% in the third quarter – mostly a result of gains in the financial sector. However, growth in third-quarter US gross domestic product was revised down, to 2.8% from an initial report of 3.5%. Inflation also remained under control, as the core personal consumption expenditure index rose an annual 1.4% in October. On the

downside, job *creation* remains moribund, and until there's a revival, growth will remain sluggish.

The S&P/TSX Composite Index retreated 1% week-over-week, as did the Dow Jones Industrial Average. The S&P 500 Composite Index ended the week flat after once again approaching its 52-week high of 1,116 earlier in the week.

So far, the Dubai debt default hasn't unrolled into a larger event. That's reflected in the relatively small retreats in developed-world stock markets last week. But there may well be more pain to come if growing fear comes to grip the markets. Crisis-level short-term US Treasury yields at or below zero are but one indication of growing risk aversion. The record-high price of gold is another. Add a flurry of year-end portfolio rebalancing and window dressing, and you have recipe for even more volatility as 2009 draws to a close. ■

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