Drobny Guest Research

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Slowly but surely, inch by inch, this USD rebound continues to build. It's not that the US is in such great shape; the sustainability of the US recovery might well be greatly exaggerated. Rather, it's that pockets of trouble and potential distress elsewhere makes the US look relatively better, and underlying flows are a good deal less negative than in the recent past. This idea shows up in today's quick Guest comment which was triggered by the discussion published in Thursday's '*Views*' piece. - *Andres Drobny*

EMG Bubble & The USD

Anonymous US HF Mgr

Very good piece. It always comes back to Brazil for me because it is the poster child for the bubble we experienced in EM. Why?

Brazil (for reasons I have outlined before) attracted a ton of capital as a derivative play on Chinese growth, specifically its demand for natural resources. Combined with its new found weak currency, the country took off. At one point, Brazil was the cheapest steel producer in the world - imagine that! Unfortunately, this happened to be when BRL was at R$3.60 vs. today's level of R$2. All of the wealth that was created was spent on consumption and wage inflation. What little investment that occurred was immaterial relative to GDP, did little to address alleviating future bottlenecks and frankly, might have been misdirected - as a reference check out anything related to Eike Batista or HRT's squandered R$2bn of exploration for oil & gas in the Amazon.

I am also on record that we may be in the beginning stage of a USD bull market. If this is the case, it addresses why many market participants are left scratching their heads to explain certain moves: KRW, BRL etc. I chuckle to myself when I hear about the BCB allowing Brazil to float to 1.95 or 1.90. Short-term that is enough to move it there as market participants jump in. Longer-term, their window to manipulate their currency stronger may not stay open for long. There will come a time when inflation is so bad that the market will test them and they might not pass. Sure they have $300 or $400 billion in reserves and aren't really at risk but the point is that this is, and always has been, a classic emerging market. "Macro prudential measures" "Unorthodox monetary and fiscal policy" a development bank and government controlled banks extended lending like it is going out of style is not the recipe for sound economic policy. I don't see a disaster in Brazil but I think that the market is too quick to give the BCB the benefit of the doubt.

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How does one trade this? Tactically. I am happy to be long BRL vs USD when things get overdone (which they are/will within this current correction) but I have an eye on 2.20 in a year. Rates - I don't see them hiking as much as is priced in (with elections coming up next year) ***but*** I think the next 3 inflation numbers are ***so important***. CB is jawboning the market now and pretending to be responsible. But, this is not a CB with hawkish credibility (yet) so caveat emptor. Equity - being short the equity has been the play but some of the large cap names are starting to get cheap so it is tough to be short for anything other than a short-term trade here. Better to have relative trades among the different asset classes here.

Now before Andres rips my head off about a USD bull market, I just read this article which I found fascinating: http://www.theatlantic.com/magazine/archive/2012/12/the-insourcing-boom/309166/ - so let's break out the old crystal ball and think about a possible scenario. Goldilocks: US growth miracle driven by new investment due to less uncertainty around taxes (even though we have higher rates we don't have the uncertainty anymore) and the old energy independence chestnut which is causing a "US Manufacturing Renaissance". In this scenario, employment picks up and Fed tightens within our lifetimes (circa 2015) which causes US short rates to price it in now and the start to a USD bull market.

Or, the world stinks because the US doesn't grow, China has an inflation problem or just has structurally slower growth and, dare I imagine an unemployment problem?, or a return of European risk or who knows what else - check out this article in the NYT the other day – ***amazing!***: http://www.nytimes.com/2013/02/19/technology/chinas-army-is-seen-as-tied-to-hacking-against-us.html?pagewanted=all&_r=0 (Chinese cold war anyone?). In that event, risk off usually equates to stronger USD.

I am getting tired of typing but how about this scenario: The Asians listened to Rubin et al and get it right and domestic demand growth accelerates. Finally, Asian final demand becomes more relevant than US demand (in aggregate), US exports increase, imports decrease and we have a trade surplus!

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