NATCAN MARKER

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THE U.S. AND CHINA: A PARTNERSHIP IN RAPID EVOLUTION

The financial and economic crisis of 2008 has brought about necessary massive government intervention leading to important budget deficits in the U.S. The magnitude of existing and projected deficits has in turn created major fears of credit downgrades, inflation and devaluation of the US currency. This edition of the Natcan Marker focuses on the review and analysis of key elements surrounding these issues.

VENDOR FINANCING BECOMES MORE PERMANENT

Globalization has been the defining trend for the world economy for over two decades. Along with free trade and expanded movement of goods came financial flows, the product of growing trade and the related need for financing to facilitate exchanges.

Nowhere is this relationship more pervasive and critical than between the U.S. and China. Consider the fact that at its recent peak, U.S. consumer spending exceeded 70% of domestic GDP and represented close to a quarter of world GDP! This level of excess consumption - relative to financial means - was made possible, in large part, by financing from the U.S.' largest vendor: China. A tacit agreement between the two countries led to the U.S. buying Chinese produced goods while in turn, China recycled excess dollars by purchasing U.S. government debt.

China's foreign exchange reserves are estimated to be $2 trillion. Of this total, 70 to 85% are held in US dollar instruments. Some observers latch onto this statistic to predict a massive dumping of US dollars by Chinese authorities. This overly simplistic view disregards a critical factor: the US dollar market is the only financial market deep and liquid enough to accommodate such sums. The fact is there are not enough equities or gold on world markets to accommodate the safe investment of such massive reserves. Some have begun to refer to the now more permanent nature of China's holding of U.S. debt securities as "the China Trap".

The fact that Chinese purchases of U.S.-issued and dollar-denominated debt have increased in 2009 over the previous year, reaching a record level in March of 2009, attests to the level of co-dependency these two financial superpowers have reached.

MULTIPLE FEARS, ONE FOCAL POINT: THE DOLLAR

Financial markets are the bloodstream of globalization. In no other arena of economic activity are adjustments so rapid and important. While financial markets are the end composite of a myriad of instruments, participants, trends and countertrends, there is one common denominator in every world region: the dominant currency.

This explains how the recent downtrend in the value of the US dollar has served as a beacon to those concerned with the path followed by that country, as illustrated by ballooning budget deficits. With a 2009 forecast deficit that will reach 13% of GDP and total debt of 42% of GDP, the U.S. is a source of worry for investors globally. As a result, the dollar has reached new lows recently and yields on long-term U.S. debt are being pushed higher by investors. Of greater importance perhaps is the fact that the Obama Administration has made clear it intends on maintaining large budget deficits for several years to come. Investors recently expressed their dissatisfaction with this view when they drove the value of the US dollar and U.S.-issued debt lower, as rating agencies warned about potential downgrades to the ratings of the UK.

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Much investor focus is centered on the financial relationship between the U.S. and China. Fears related to the abandonment of US dollar assets by Chinese authorities appear overdone. China will however play an increasing role in pressuring U.S. authorities to right their budgetary situation. Investors can expect many more public declarations by both parties and should remember that actions speak louder than words.

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FINANCIAL MARKETS

RETURNS AS AT JUNE 12, 2009 (%)	MTD	QTD	YTD
S&P/TSX	2.80	22.91	20.44
S&P 500	5.53	5.68	-2.58
S&P/TSX Small Cap	3.80	28.28	23.55
Russell 2000	7.63	10.79	-2.39
MSCI EAFE	4.48	14.80	0.69
MSCI World	4.68	10.59	-0.73
DEX Universe Bond	0.54	0.43	1.96

	RATES AS AT JUNE 12, 2009
CAD/USD	1.12
CAD/Euro	1.56
US Treasuries yield 10-yr/30-yr	3.79/4.63
GOC bond yield 10-yr/30-yr	3.51/3.94
Fed Fund Rate (target)	0.25

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. All rights reserved.