



Wealth Management Consultants Inc.



BULLETIN

Oct. 2009

- **Macroeconomics and EMH**
- **The A-B-C's of the P-P-P's of Foreign Exchange Rates**
- **Some risks are unforeseeable...**
- **Book review: *False Economy, A Surprising Economic History of the World***
- **Selection of Financial & Economic Indicators**



Macroeconomics and EMH

Now that we experienced a period of unprecedented and unthinkable turmoil in financial markets, how much confidence is left in traditional macroeconomics? Was Paul Krugman correct when he stated that the "most

macroeconomics of the past 30 years was spectacularly useless at best and positively harmful at worst"?

Macroeconomic theories took a big hit in the 1970's because stagflation (high unemployment at a time of high inflation) was not supposed to happen. This led to a lively debate between those who felt the fault was with the central banks not having done enough to prevent it, and those who felt that the central bank had done too much, hence had caused it. Over time economists concluded that the truth was likely somewhere in the middle.

Macroeconomic models are not useless, they can help us understand what is happening and why, and they can be a guide to the future. The problem is when too much confidence is placed in them, for the models are neither complete nor fail proof. Economic choices expressed in the models do not always reflect the real world, for example many models assume that insolvencies cannot occur. Thinking based more on convenience than on conviction led many bank to conclude that short-term debt could always be rolled over and that there would always be a market for mortgage-backed securities.

Finance is not frictionless as we have learned at great cost after a quarter of a century of relatively smooth sailing. Increasingly we are

running into bubbles, yet those very bubbles are not supposed to exist if the EMH, the efficient market hypothesis, holds true. If prices of financial assets reflect all available information, then asset prices must be correct and there is no room for bubbles. It is based on this that much financial engineering was done in recent years. And much of what was developed indeed worked out as expected and for while made the financial system safer, made economies healthier and most importantly, made bankers richer.

What proved disastrous were the exceptions to the norm which were not supposed to happen. Alas they did, leading market participants to become irrationally risk adverse. In a recent article The Economist mentioned that in summer of 2007 a simulation from the Fed's FRB/US model predicted that a 20% fall in US house prices over two years would reduce GDP by only 0.25% and increase unemployment by 0.1% if the Fed would "aggressively" cut rates by 1%. If that is not a reason to rethink everything we know about economics and finance...

The point is that modeling gives us a lot of insight, but we cannot afford to blindly believe what the models tell us. The big unknown will always be human behavior. Until this can be modeled, the result of any simulation must be taken with a big grain of salt!



By Rolf Spielmann, CFA
Senior Vice-President of BLUE BRIDGE™





The A-B-C's of the P-P-P's of Foreign Exchange Rates

The U.S. Dollar – “the Buck” – has declined 20% from its peak versus a basket of currencies at the height of the technology boom in 2002. Does this decline mean the demise of the U.S. dollar’s role as “the world currency”, which it has played for six decades? Clearly, the Buck today remains the standard of foreign trade and finance; for example, many commodities such as crude oil are priced in U.S. dollars. But with major economies such as China’s and several oil exporters diversifying their foreign reserves, and some Eastern European countries focusing on the Euro even without membership in the European Monetary Union, the dollar may be facing competition. So how valuable is the dollar?

Economists use a concept called purchasing power parity (the “PPP” of this note’s title) to estimate the fundamental value of one currency versus another. Here’s a simple example – the so-called “Big Mac Index”. *The Economist* magazine occasionally publishes this index, which is based on the price of McDonald’s hamburgers in different cities. For example, suppose a hamburger costs US\$3 in New York, £2 in London and ¥300 in Tokyo. Then the Buck “should” be worth US\$1.50 to £1, while a hundred Yen “should” be worth one U.S. dollar for equivalent amounts of currency to buy one hamburger. These exchange rates would be the purchasing power parity rates. In fact, the current exchange rate is approximately ¥90 to the Buck and US\$1.65 to the Pound, so if hypothetical hamburger index would imply that the Yen was 10% too valuable versus the U.S. Dollar which in turn was 10% too cheap versus the Pound.

By using price indexes covering a wide variety of goods and services, and longer measurement periods going back 60 years, economists can estimate PPP exchange rates more accurately than a one-time hamburger index allows. Using PPP estimates, the U.S. Dollar appears undervalued versus a basket of major currencies

by only 2%. It is not wildly different from its PPP value.

This average, however, masks differences compared to specific currencies. The U.S. dollar is now 10% undervalued versus the Euro, but 8% overvalued versus the Pound and 18% overvalued versus the Yen. All of these figures are within normal historical bounds. On the other hand, the Canadian “Loonie” appears to be about 33% overvalued versus the Buck, a statistically and economically significant value. We believe this mis-valuation is due mainly to elevated prices of many raw commodities, especially crude oil, and despite lower prices on natural gas and lumber. So the seeming mis-valuation could be justifiable and persist for some time.



In sum, while the U.S. Dollar could weaken further, at present it remains the world’s currency and hovers near the average fundamental value, the PPP, that it has enjoyed on average for more than half a century.



By Matthew Gelfand, Ph.D., CFA, CFP®
Managing Director
Lynx Investment Advisory, LLC
Washington





Some risks are unforeseeable...

The market rebound since late March has surprised quite a few market operators. Although the causes justifying this trend are easy to see in retrospect, few managers anticipated it. In the June 2009 newsletter, I took the liberty of reporting that a great majority of the flexible managers we were recommending to our clients had increased the portion of equities in their portfolios. I added that this movement represented a clear break from their behaviour in the previous months and that it would be unadvised to ignore this signal. The trend has been confirmed since then, and these managers have been raising their risk positions on a regular basis.

Some clients, for easily understandable reasons of caution, have chosen to stay away from risky assets and, finding themselves underexposed today, are wondering if now is a good time to get back into the markets. Answering in the affirmative seems reasonable to me, provided the equity investment is accompanied by an effective measurement of the risk taken.

The recent financial crisis showed that financial models of risk-measurement are deficient, stressing typical or normal market behaviour based on the hypothesis that the price distribution of risky assets follows a normal rule. The reality is quite different: financial volatility is not unusual, so-called extreme risks are likelier to occur than indicated by classic ratios, and the

consequences of losses are also greater than estimated by these models.

Investing today, with volatility (or VaR, the Sharpe ratio, etc.) seen as an effective way to measure risk, seems unreasonable. Some risks are unforeseeable, and it is important to find tools that offer assurance against the financial consequences of extreme risk.



Wise investors will have an easier time returning to equity markets if they have taken the precaution of investing symmetrically in hedges against extreme risk, such as out-of-the-money options or long positions on implicit volatility (the VIX, for example).

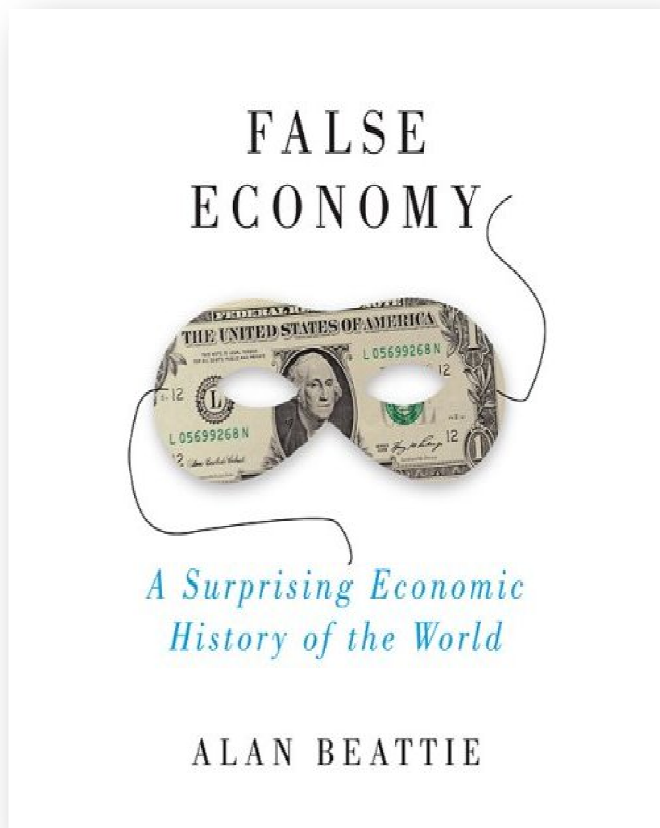


By Luc Granger
Associate
Intuitae Paris



False Economy
A Surprising Economic History of the World

By Alan Beattie
Riverhead Books, 2009



Mr. Beattie is a leading economic writer. He is a former economist of the Bank of England and is currently world trade editor of the Financial Times. He has written an entertaining, yet

detailed and thought provoking book on why some economies prosper why others fail. As a prime example he looks at the developments of Argentina and the US, both countries blessed with an abundance of fertile land and populated with European immigrants. A century ago Argentina was the success story, today and for much of the recent past it is a basket case and the US is still the dominant superpower.

In this book Mr. Beattie argues that it is not destiny that makes societies rise or fall, no that it is the good or bad decisions of political leaders that make the difference. He examines a number of cases, such as why Islamic nations do not get rich (the Qur'an's dictum against usury and interest earning?), why Peru controls the global export of asparagus (excellent lobbying?), why Africa does not grow cocaine (poor infrastructure?), why Pandas are endangered (dieting almost exclusively on bamboo?), why command economies are doomed (inefficient bureaucracies, inflexibility?).

We learn how roads and climate influence where crops are grown and how and where those crops are processed. We learn how and why the ancient food exporter Egypt became a food importer. Indeed Mr. Beattie takes us all over the globe in what sometimes appears to be a somewhat unorganized (yet always entertaining) story.

By looking back Mr. Beattie concludes that history proves that humanity has the ability to make the correct choices going forward. As he writes, history is not determined by fate, it is determined by people. It is a hopeful book; it is also a book that should get us thinking about the quality of the politicians we elect!



Selection of Financial & Economic Indicators

Indice	DJ Ind	DJ Transp.	Nasdaq	S&P500	S&P/TSX	
September 30	9712.28	3799.84	2122.42	1057.08	11394.96	
Monthly var.	2.27%	3.62%	5.64%	3.57%	4.85%	
Year-to-date	10.66%	7.43%	34.58%	17.03%	26.78%	
Year-over-year	-10.49%	-17.68%	1.93%	-9.24%	-3.05%	
Indice	FTSE	DAX.	CAC40	SMI	NIKKEI	EURO50
September 30	5133.90	5675.16	3795.41	6323.18	10133.23	2872.63
Monthly var.	4.58%	3.85%	3.88%	1.71%	-3.42%	3.51%
Year-to-date	15.78%	17.98%	17.94%	14.25%	14.38%	17.18%
Year-over-year	4.72%	-2.67%	-5.87%	-4.98%	-10.01%	-5.45%
Mat. premières	OR	CUIVRE	PETROLE	CEREALES	BOIS	CRB
September 30	1009.30	281.45	70.61	457.50	168.70	259.39
Monthly var.	5.97%	-0.81%	1.35%	-8.27%	-5.12%	2.25%
Year-to-date	14.56%	101.11%	64.21%	-25.49%	-0.65%	17.48%
Year-over-year	15.57%	-2.43%	-30.32%	-32.72%	-17.30%	-24.86%
Devises	\$CA	¥	€	£	\$AU	
September 30	1.0695	89.7500	1.4640	1.6008	0.8840	
Monthly var.	2.28%	3.65%	2.09%	-1.71%	4.62%	
Year-to-date	12.26%	1.21%	4.87%	9.79%	25.39%	
Year-over-year	-0.49%	15.61%	4.05%	-9.97%	11.90%	

Alain E. Roch, MBA

President | alain.roch@bluebridge.ca

Rolf Spielmann, CFA

Senior Vice President | rolf.spielmann@bluebridge.ca



Blue Bridge Wealth Management Consultants Inc. | www.bluebridge.ca

1800 McGill College Avenue, Suite 2108, Montreal (Qc) H3A 3J6 Canada
Tel. +1 514 845 9165

Blue Bridge is an independent wealth management consulting firm that provides investment advice to high net worth individuals.

The information contained in this report is not guaranteed in any manner whatsoever. It is for information purposes only, and does not constitute a recommendation to buy or sell stocks, bonds, currencies, and/or any other values. This newsletter cannot be reproduced in any way and/or for any purpose without the express authorization of Blue Bridge Wealth Management Consultants Inc.



Copyright © 2009 BLUE BRIDGE Wealth Management Consultants Inc.