HEDGE FUNDS REVIEW

China, US Treasuries and the dollar seen as most likely candidates for the next bubble
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Bookmark and Share China and the US economy are the most likely candidates for the next bubble. China exhibits many of the tell-tale signs. The US economy represents a bubble, supported by government stimulus measures.

[...]

Fabrice Seiman, Lutetia Patrimoine Fund

The markets' recent enthusiasm for high-yield bonds, technology stocks and commodities is largely irrational. Recovery may be on track in both developed and emerging economies but investors should remain extremely cautious: sovereign debt levels in almost all Western countries continue to rise and the major currencies are especially volatile. Of particular concern are difficulties in the US job market where unemployment by some measures still stands at 16%, despite the International Monetary Fund's projections of 2.3% GDP growth in 2011.

The apparent contradiction between an IT or commodities bubble and a still-uncertain recovery is largely explained by unconventional monetary policies among Western nations. By issuing currency to acquire assets from banks, quantitative easing programmes have artificially fuelled some segments of the financial markets.

Policymakers have effectively bet they can sustain growth through monetary policy while putting public finances and financial institutions' balance sheets back in order. They actually might be proven right in the medium term, in part thanks to growth coming from the emerging markets. However, this could come at a cost, namely the burst of some of the bubbles encouraged by the unconventional central banks interventions.

High uncertainty over the near future must lead investors to favour absolute-return strategies with very low market beta such as merger and acquisition arbitrage. M&A activity is expected to boom in coming months. Record high corporate cash reserves, historically low interest rates and sector-based drivers are likely to encourage big corporations to choose external growth. Combining moderate leverage with significant returns, M&A arbitrage is probably the best option for investors wishing to minimise their exposure to a volatile macro environment.