And It's One, Two, Three! What Are We Trading For?

If you found yourself singing along with this title, you are of a certain age. This is the chorus of Country Joe & the Fish's *Feel Like I'm Fixing To Die Rag*, made famous at Woodstock in 1969. The song actually opens:

> Come on all of you big strong men
> Uncle Sam needs your help again
> he's got himself in a terrible jam
> way down yonder in Viet Nam so
> put down your books and pick up a gun we're
> gonna have a whole lotta fun

Country Joe McDonald, by the way, was named after Josef Stalin. That must have been some household.

Our purpose here is not to re-fight the Vietnam War, even though this war has been fought and re-fought in our never-ending cultural wars for the past forty years. Massive shocks have a way of reverberating for a very long time; consider the oft-told and possibly apocryphal tale of Chinese Prime Minister Chou En-Lai in 1972 describing the impact of the French Revolution on Western civilization as "too early to tell." All global history since 1914 has been a footnote to World War I, we are still living with the economic aftershocks of the New Deal and chances are very high everyone reading this will be living with the consequences of the 2007-2008 collapse of Wall Street's institutional model for the rest of their lives.

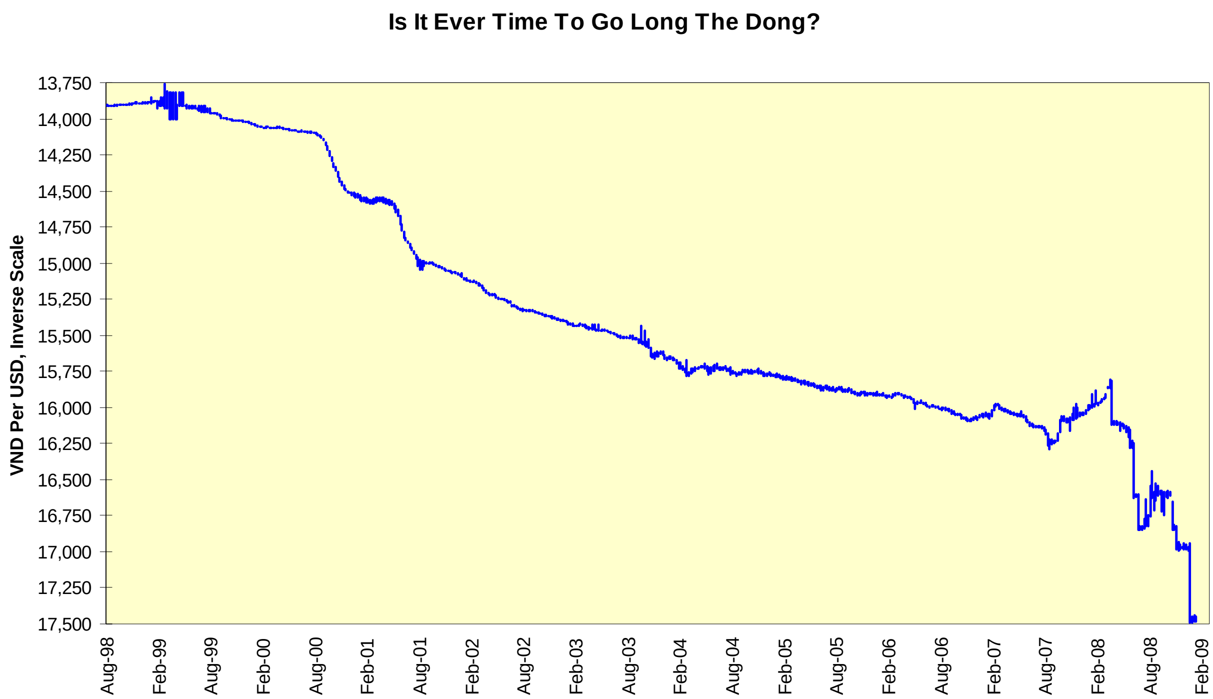
The Vietnamese Dong

Credit bubbles and their aftermaths have a way of making bull market geniuses and then dethroning them. Such was the case for emerging markets; between May 2003 and October 2007, the Morgan Stanley Capital International Emerging Markets Free index rose by 375% in USD terms, an annualized rate near 41.8%. The money flowing into those equity markets often strengthened the underlying currencies perforce. Capital inflows do that; as we have seen in many of the articles in this series, the linkages between relative asset returns often are as determinant of currency movements as are relative interest rate expectations.

Markets push to extremes; indeed, we can argue this is one of the vital functions of a market. Sometimes these extremes are visible in price; sometimes these extremes are visible in geographic extension. In the case of emerging markets, a new term, "frontier markets," was coined to describe these extensions. Vietnam and its currency, the dong (VND) became a poster child for frontier markets.

A long-term chart of the VND is vaguely reminiscent of the way the Brazilian real used to trade between 1995 and January 1999; it had a long, slow and very regular devaluation between 1999 and August 2007. Then as the USD started to decline under Bernanke's loose-money fiesta between August 2007 and March 2008, the VND actually firmed against the greenback. As an aside, this is a rather damning observation about American monetary mismanagement over the period. After March 2008, the dong began a very abrupt collapse against the dollar.

A final, so far, devaluation came during the last week of December 2008 as the State Bank of Vietnam allowed the VND to fall an additional 3% in an attempt to stimulate the country's export sector. As an aside, such competitive devaluations seldom work and indeed have the effect of impoverishing the country doing the devaluation. But like deficit spending, manic cutting of interest rates and tax rebates, governments and central banks persist in such policies out of intellectual bankruptcy as much as anything else.



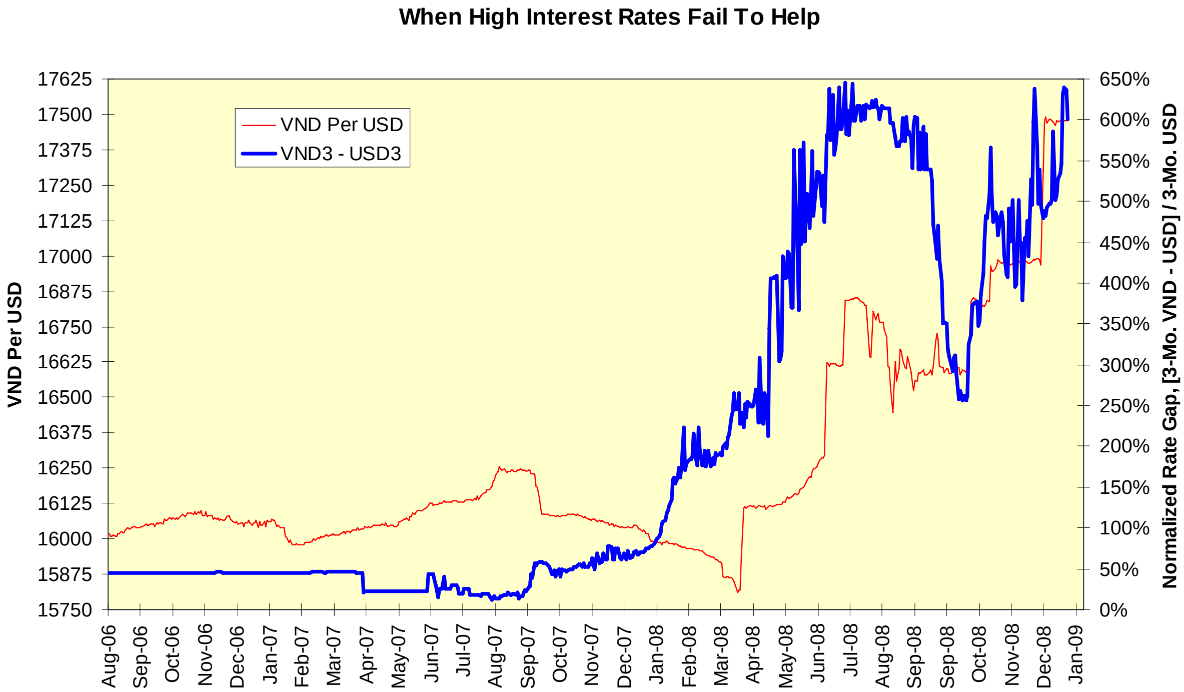
Interest Rate Differentials

What is interesting about the dong's post-March 2008 collapse is how rising interest rate differentials between the VND and USD did nothing the protect dong; while rising three-month dong rates made the currency more expensive to borrow, they did not rise sufficiently to forestall traders from doing so. Dong rates rose steadily between August 2007 and January 2008, and the VND firmed in response. But markets are discounting mechanisms, and the rising credit crunch around the world meant capital outflows were increasingly likely.

The normalized rate gap, the difference between three-month dong and three-month dollars divided by the three-month dollar rate, rose from 12% on August 10, 2007 to 265% on March 24, 2008. This normalized rate gap is used instead of the 6-9 month forward rate ratio commonly used in this space because there is no comparable swap market for Vietnamese instruments. This forward rate ratio, as a refresher, is the rate at which you can lock in borrowing for three months starting six months from now, divided by the nine-month rate itself.

After March 24, 2008, the Vietnamese did in the interbank market what they never did during decades of almost continuous warfare; they more or less abandoned the fight. The VND fell from 15,820 to 16,110 in just three trading days. By July 8, 2008, it hit 16,850.

The dong then stabilized as it was the Americans' turn to abandon longstanding principles in September-October 2008, but after mid-October 2008, the interest rate gap widened and the dong collapsed to new lows. Failed American and failed Vietnamese policies intersected in time to the detriment of both countries.

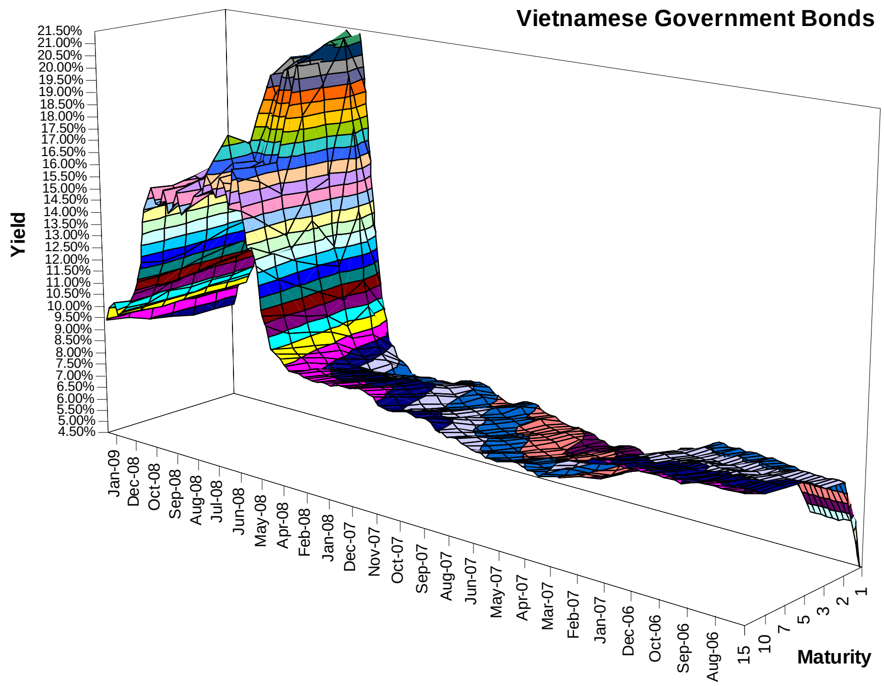


In reality, Vietnam simply relearned what others had learned before: If you try to fix your currency rate by pushing short-term interest rates increasingly higher, you will lose eventually. They could have consulted the Bank of England in this matter; the BOE famously lost a similar fight to George Soros in September 1992. Higher interest rates signal the market the currency will fall in their absence; this is not the signal you want to send.

Bond Markets

What did all of these short-term interest rate movements and currency gyrations do to the Vietnamese bond market? The answers are very simple. The first in Vietnamese bond rates rose across the maturity spectrum. The second is the Vietnamese yield curve moved from positively sloped to negatively sloped (inverted) by the summer of 2008. This was a brutal combination for capital markets: Not only was money more expensive, the shape of the curve indicates the market expects higher short-term interest rates to slow the economy.

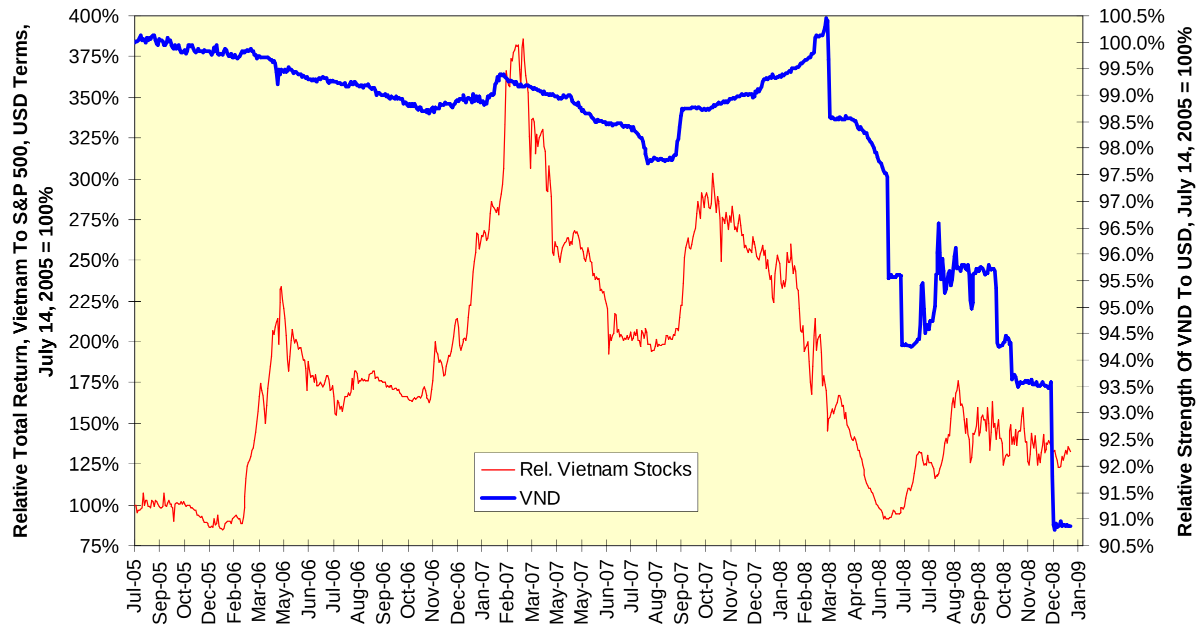
But then the Vietnamese bond market was rescued, after a fashion, by the deepening world recession. Yield across the yield curve peaked after mid-October and then plunged back to April 2008 levels by the December devaluation. Moreover, a positive slope was restored to the yield curve. But what markets give, policymakers can and do take: The government issued VND 36 trillion in bonds to fund its stimulus program. Unlike the case in the U.S., where policymakers can abuse the dollar's role as a reserve currency and fund the American deficit at lower rates (see "Sovereign Credit Risk and Currencies," March 2009), the extra bond issuance halted the Vietnamese bond rally in its tracks.



Surprising Reaction In Stocks
If the reaction in Vietnamese bonds to currency volatility was negative, as we should expect, what was the reaction in Vietnamese stocks? Here we can compare the relative performance of the Hanoi Stock Exchange index to the S&P 500 in USD terms, but we can do it only from July 14, 2005 onwards. Remember, they call these frontier markets because they involve borderline lunacy to trade them.

The relative performance of the Vietnamese market peaked way back in March 2007. For those unable to remember where this is on the crisis timeline, it was after the huge late-February 2007 in stocks and the successful test of that low in early March. Restated, the U.S. market recovered far more rapidly than did the Vietnamese market.

The Relative USD Return On Vietnamese Stocks Broke Before Dong Did



The relative slide in Vietnamese equities abated in September-October 2007, only to accelerate into June 2008, a period in which the VND was firming. It also fell when the VND collapsed after interest rate hikes were abandoned as a defense of the dong. Up until June 2008, an observer would have had to conclude the Vietnamese stock market and currency were unrelated on either a lead/lag or a contemporaneous basis.

That shifted from July 2008 through mid-October 2008. Now the two markets moved contemporaneously, for better or worse, as both became measures of global risk-seeking and aversion. Incredibly, the relative performance of Vietnamese equities did not plunge along with either the dong or the end of the bond rally in December 2008. Hope springs eternal for equity investors worldwide.

What can we conclude from this Vietnamese case study? First, no country should attempt to defend its currency with higher interest rates. The cure generally is worse than the disease. Second, while investing in emerging markets often is an exercise in linked currencies and equities, the two can remain unlinked for very long periods of time. Third, frontier markets and frontier currencies are so small with respect to the pool of investable funds sloshing around the world that these countries are entirely at the mercy of the capital markets.

Finally, anyone could be excused for saying, “We learned this with the Asian crisis of 1997-1998.” The answer is, “Yes, but we get to learn the same lessons over and over.”