Don't Poo-Poo Peru

I have to confess the proliferation of exchange-traded funds over the past few years, a proliferation that seems to be accelerating to the point where, if left unchecked, there will be more ETFs than underlying assets but not, thankfully, of subsets of assets, has left me wondering, "Where have I seen this before?" The answer came to me in a blinding flash of too-much-nutmeg-in-the-eggnog hallucinations: A 1960s-era commercial for a dog food called Gaines Burgers, the first canine munch-a-bunch ever sold with the tagline, "Is your dog getting enough cheese?"

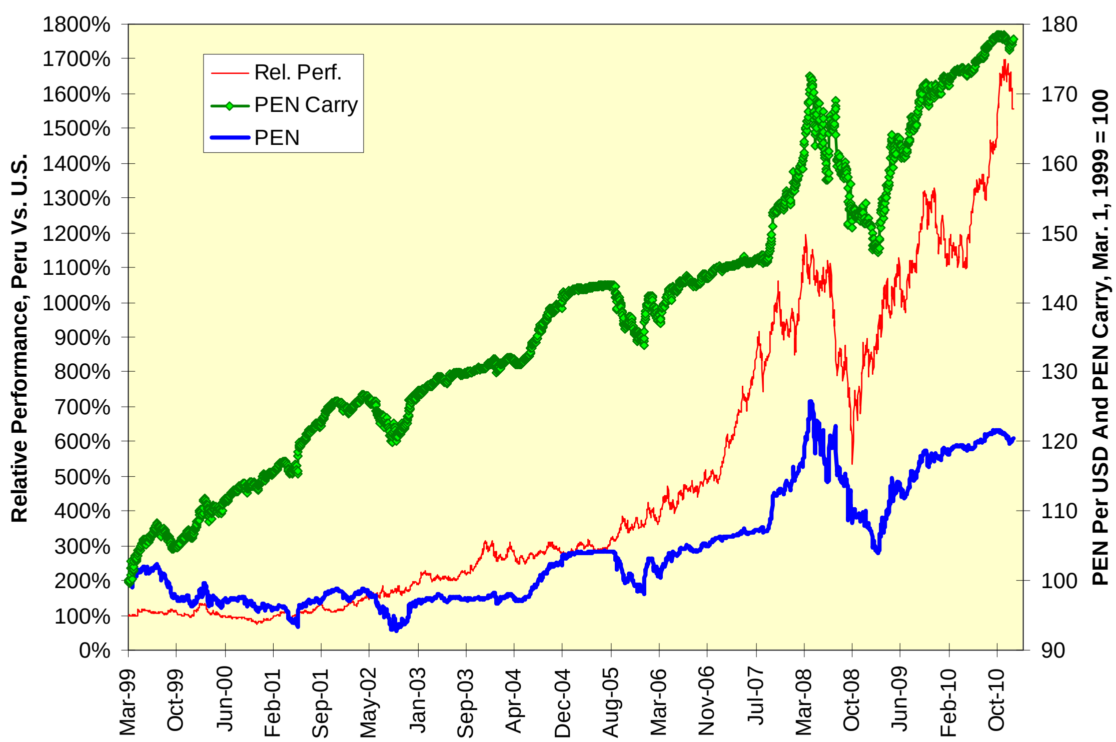
Which brings us to our topic here today, does your portfolio have enough exposure to Peru? Don't lie; does it? If it does not – and I use that "if" subjunctively as we both know the answer is, "No," you can rectify the situation by buying the iShares MSCI All Peru Capped Index fund (EPU) which, we are assured "invests in a representative sample of index stocks using a 'portfolio sampling' technique." And, please note this is an "All Peru" index; accept no Partial Peru substitutes.

One More Carry Trade

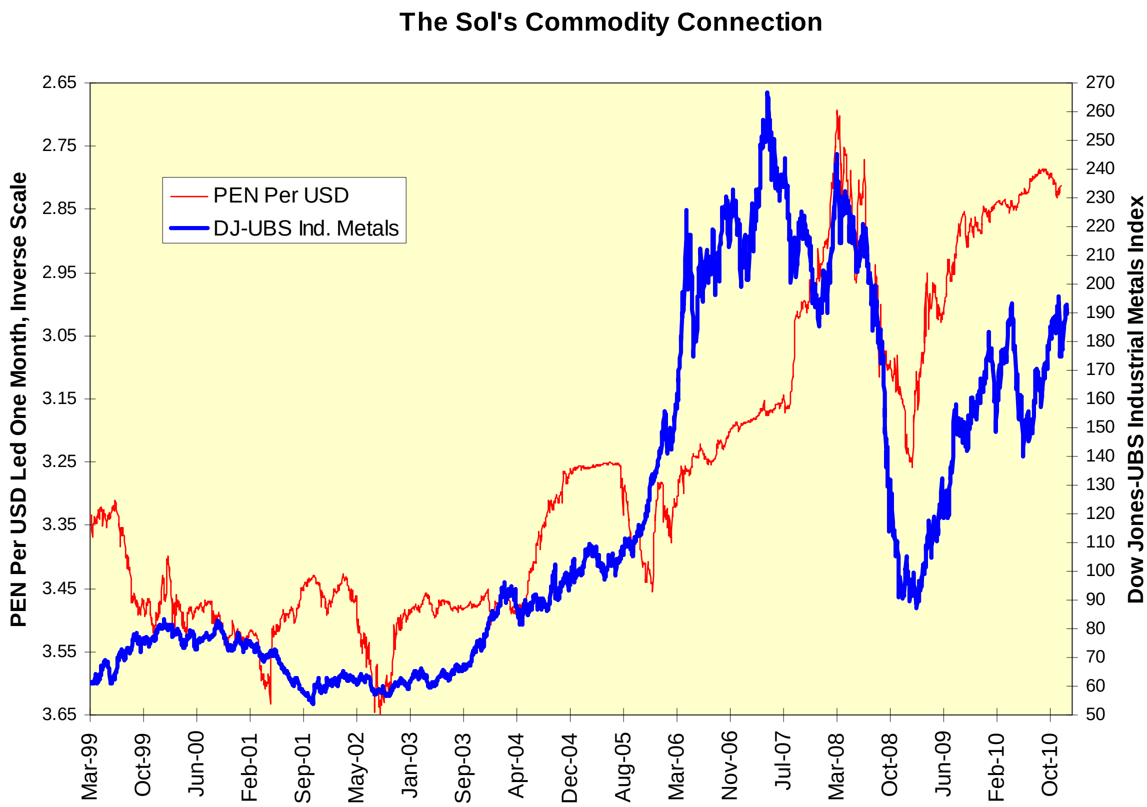
The return on the EPU has been a cool 58.4% year-to-date, which should be our first clue something related to carry trades is involved. Our second clue is the two top-performing stocks in Lima in 2010 have been Rio Alto Mining and Candente Copper; wherever hot money is involved, resource stocks tend to get rewarded. With that, fellow members of the Sherlock Society, let's see if we can establish a carry trade connection.

First, let's map the relative performance of the Peruvian to U.S. markets in USD terms as measured by MSCI-Barra against both the spot rate on the Peruvian sol (PEN) and the excess carry return from borrowing the dollar and lending in the sol. The huge runs since the U.S. decided to adopt a money-printing strategy in March 2009 in both the excess carry return and in Peruvian stocks have been somewhat parallel. That is correct: Thanks to the Federal Reserve, dollar-holders are fleeing to the Peruvian Andes and to the stocks located therein.

Peruvian Performance Linked To Carry Trade After March 2009



Next, let's use the Dow Jones-UBS industrial metals sub-index as an indicator for Peru's mining sector and map the PEN against it. It seems the two markets are more than "just friends;" this has been especially true since March 2009.



The conclusion is rather straightforward. I hesitate to call it a virtuous cycle as I find our monetary policies to be lacking in virtue, but the dollar carry trade into Peru is forcing both the currency and the equity markets there higher. Simultaneously, the rebound in global industrial demand which may or may not be linked to our money-printing is making the Peruvian mining sector an even more attractive home for dollars looking for a return.

This is a self-reinforcing cycle. As I define a bubble to be self-reinforcing behavior, I have to say Peru's markets are in a liquidity-fueled bubble whose fate will not be decided in Lima but rather in Washington. However, as Washington seems congenitally incapable of doing anything other than print money and create debt, Peru might be a good place to hang out for a while.