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## China to carry loonie past US\$, Mersch says

The loonie should hit US\$1.05 within a few weeks, says Frank Mersch and could pass US\$1.10 if the price of oil breaks US \$100. Canada will continue to benefit from China's voracious appetite for resources but the celebrated hedge fund manager also warns of inflation, particularly of food prices.

Mersch, chairman and vice president of Front Street Capital, made a rare public appearance on Tuesday night at the Granite Club in Toronto. Unlike during his heyday at Altamira Investment Services Inc., Mersch rarely speaks to the press these days.

Former Altamira colleague Francis D'Andrade persuaded Mersch to give a talk to clients of DOT Integrated Financial. Mersch spoke off the cuff for an hour. As the edited transcript of an interview that ran at [www.financialpost.com](http://www.financialpost.com) yesterday made clear, Mersch believes Canada is still in the sweet spot of the commodity cycle. "China is a driver. Canada is a beneficiary" of rising demand for commodities like fertilizer and potash.

By contrast, "the U.S. is not the driver of this cycle," he told the audience. "The key driver for this cycle is the industrialization of China and subsequently India." He described this phenomenon as being "ten times" as large as the Marshall Plan to reconstruct Europe and Japan after World War II.

Four years ago, China was the world's seventh-largest economy. Today's it's third and will be second in three or four years, Mersch predicts.

"As China continues to expand and provide further growth to the global economy it is using up all the resources of the world."

Mersch warned the first signs of food price inflation are already beginning to show up; raw food prices are up 25% the last year, he said. In China, the price of pork has risen 30% in three months. "We are creating inflation pressures that could come home to roost."

Cheap Chinese goods have been deflationary but those prices can't continue to fall much longer. The world is approaching an "inflection point" where the price of Chinese goods will rise along with the price of materials like steel or feed. Nor will China's cheap labour continue indefinitely. "We're already seeing wage inflation in China. They're using Viet Nam and other Asian areas to procure cheap labour."

Front Street believes commodity and food prices will go higher. When wheat is at \$9/bushel someone has to pass those costs along, Mersch said. He expects corn to hit \$12/bushel and "probably" \$16. "We are taxing the world's resources and water will be one of the biggest issues."

The U.S. federal reserve may claim to be concerned about cyclical or secular inflation but Mersch said the Fed "buckled" on Tuesday when it lowered interest rates and more significantly the open window rate by 50 basis points. "They bailed out rich Wall Street guys."

Mersch is surprised by the complacency of a market that was up even after a run on two British banks. He describes the U.S. energy policy as "a joke." While the Bush administration frets about Iran's attempt to build a nuclear facility ostensibly for energy purposes, "China is building 33 nuclear reactors and no one says a word, and they have a billion people in their military."

He predicts that in our lifetimes, the U.S. dollar will "no longer be the reserve currency of the world." Investors should be thinking baskets of Euros and Singapore, Canadian and Australian dollars instead of putting all their investments in the U.S.

The forestry industry has been hurt by the rising loonie but Mersch predicts there will be a "wonderful lumber cycle in two or three years."

Asked in a question-and-answer session where the TSX will be at year-end, Mersch replied "I have no idea. I was hoping it would be negative this year. It's been pretty good for five years and I think something will come out of left field: a black swan raising its wings." Key drivers will be oil reaching US\$90 or nickel at \$15 or \$17/pound.

Canadians can participate in the China boom by staying right here in Canada. Mersch said there are four or five medium-to-small-cap Chinese companies listing on the TSX.

"They're using our markets to raise money but they are 100% Chinese companies. You get your China play with Canadian regulations and Canadian accounting and some Canadian directors. You don't have to worry about country risk or accounting risk."

Asked when Front Street would start to diversify outside Canada, Mersch said he's never had much foreign content or bonds in his portfolios the last 25 years. However, "there will be a time when we have to exit Canada; maybe when the loonie reaches US\$1.10 or US\$1.15."

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