CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

April 29, 2016

Uncertainty and the Central Banks

After weeks of intense selling in stocks, in oil and other commodities as the new year began, markets have recovered in recent weeks. The dramatic plunge in oil prices from above $110 per barrel in the first half of 2014 to below $28 per barrel in January of this year caused acute economic stress in oil producing countries and was accompanied by similarly sharp declines in other industrial commodities.

With extremely low oil and commodity prices, many economies in the developing world face recession conditions

By

Jack Mayberry

At the worst of the financial crisis in 2008, in the days after the collapse of Lehman Brothers, the major central banks, lead by the Federal Reserve, undertook a series of hitherto untested actions to prevent an utter collapse of the global banking system. These included guaranteeing all money market funds and extending essentially unlimited lines of credit to the central banks of other developed nations. Although it is impossible to demonstrate what would have happened if the Fed had not taken such extraordinary measures, it is widely believed that the Fed's actions were decisive in preserving a functioning banking system and keeping the world from falling into an economic depression.

After the immediate crisis passed, the Fed began several rounds of asset purchases, which came to be called Quantitative Easing or QE. Within a few years, these purchases expanded the Fed's balance sheet from $800 billion as the crisis began to $4 trillion now. The purpose of the bond purchases was to stimulate economic growth. In time, the European Central Bank (ECB) and the Bank of Japan (BoJ) followed the Fed's lead and began their own QE program and other strategies.

The exceptional monetary policies by Fed and the other central banks were not complemented by correspondingly bold fiscal policies. ('Fiscal policy' refers to spending, investment and taxation policies by governments.) The financial crisis caused the worst recession of the post-war era. Spending by individuals and companies slowed precipitously in the crisis and recession and private savings grew by large amounts. In this situation, economic recovery was sure to flag unless governments would take up the slack and increase their own spending. After the fairly large stimulus package enacted shortly after Obama took office in 2009, Republicans in Congress opposed further government spending and argued in favor of fiscal austerity. The ostensible reason for the Republican position, apart from the ideological preference for small government, was that increased federal spending would lead to ballooning federal deficits, increased borrowing costs, and hyperinflation. In Europe, the same arguments prevailed and fiscal austerity was the rule.

The basis for the austerity argument was soon shown to be without merit. Inflation fell, deflationary pressures increased, borrowing costs (i.e., yields on government bonds) fell to historically low levels and the budget deficit fell. Meanwhile economic growth remained anemic in the US and, in Europe, economies drifted in and out of recession. Despite the evidence against it, fiscal austerity remains the rule in Europe. In the US, some hard fought battles between Obama and Congress have increased federal spending by a bit. Nowhere, however, are governments availing themselves of the inexpensive borrowing to make investments in infrastructure, despite the crying need for highway and bridge repair and the need, especially in the US, for better internet connectivity.

The remarkable monetary policy actions certainly helped financial markets in the last few years; probably they helped to stimulate economic activity. Now though, as the economic recovery and stock market rally enter their seventh years, it becomes clearer that the central bank tools are not magic wands for economic growth or financial markets. The apex of confidence in central banks came in 2012, when ECB president Mario Draghi promised to do 'whatever it takes' to assure that the eurozone crisis would be contained. In the event, Mr. Draghi's promise was sufficient; the ECB was not called upon to take the actions Mr. Draghi had outlined.

Central bank magic appears to have run its course: Earlier this year, the BoJ expanded its policy of negative interest rates. Very tellingly, the Japanese yen rallied rapidly and strongly against the US dollar, precisely the opposite of the expected and intended result. And, ever since last summer, the Federal Reserve has been forced to back away from its planned increases in the short-term rates it controls directly, despite reasonably strong growth in the US. Volatile financial markets and China's policy missteps have stayed the Fed's hand, showing the limitations of the Fed's ability to set policy and shape economic outcomes.

Investment implications. This matters for investment markets now, because underlying fundamentals are weakening. To discuss the US alone, note that corporate profits are falling while stock valuations are rather high. Although economic growth has been persistent here, it is far from robust. (Yesterday's estimate of US GDP growth in the first quarter of the year was an underwhelming 0.5% annualized.) Job creation in America has been steady and strong, but most new jobs have been quite low paid and wage increases have been vanishingly small. The very sharp rise of the US dollar in 2014 and early 2015 depressed US corporate profits and effectively tightened monetary conditions here. The Fed would like to raise rates, but it is fearful that rate increases will cause market turbulence, weaken economies in developing countries, and cause the US dollar to rise even higher. In recent speeches and announcements, Fed members have expressed concern about the effects on the US of policy actions taken by other countries, especially China.

Market participants are well aware of the Fed's problems and the somewhat different ones that face the BoJ and the ECB. Noting the doubts about the efficacy of monetary policies undertaken by the major banks and the persistence of weak economies, commentators have begun discussing a yet-untried, even more remarkable policy, so-called 'helicopter money.' The phrase comes from a famous speech given by Ben Bernanke 2002, before he became the Fed's Chair, discussing various unused monetary policy tools. In current parlance, it refers to the possibility of a central bank making direct transfers of cash to citizens, with a view to forestalling deflation and encouraging spending. This is a bold approach to the problem of stagnating economies; its very radical nature testifies to the intractability of economic problems. To me, it suggests that the economy and financial markets are fraught with risk, the solutions for which defy central bankers and government policy makers.

In the last two months, the S&P 500 essentially recovered all the ground lost in the intense selling early this year. However, other measures of the US stock market (e.g., small company stocks) and virtually all major non-US stock markets are still well below their highs from 2015. Stock markets may well go higher from here—the general rule about stock markets is that they confound virtually all participants. We see our primary work as safeguarding the investment capital of our clients. At this juncture, a low allocation to stock markets is in order.

CORE Comments

CORE ASSET MANAGEMENT

PO Box 1629
108 Caledonia Street
Sausalito, California 94966
(415) 332-2000 • (800) 451-2240
fax (415) 332-2151
www.coreasset.com
info@coreasset.com