CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

October 21, 2012

Central Banks Confound the Cautious

As we move into the year's last quarter, the overall situation looks more robust and healthy than only a few months ago. The painfully slow economy in the US is improving. Jobs are more plentiful; people are spending more and have more confidence in the economy. The housing market is improving modestly, with higher home prices and more building. In Europe, the overall economy is in recession and is unlikely to grow in 2013 by more than a nominal amount. But the dangers presented by the sovereign debt crisis in the 'peripheral' Euro-zone countries have lessened: The extraordinary (if contingent) commitment by the European Central Bank (ECB) to assist Spain, Italy and others coupled with the apparent resolve by Germany and other leading actors to prevent a break-up or collapse of the Euro have restored calm and taken the edge off the still-unresolved crisis.

To be sure, problems are readily apparent. The so-called 'fiscal cliff' looms in the US. Without a deal among the houses of Congress and the administration in the lame-duck session, income and payroll taxes will rise as of January 1 and sharp cuts federal spending will unfold. Should there be no deal, the US economy would almost certainly contract because of the far tighter fiscal backdrop. Financial markets would be shaken. At present, the expectation is that some sort of deal will be achieved. Because of the completely unresolved problems in Europe, a crisis there may arise in any number of ways. China, the world's second largest economy, has been weakened by economic contraction in Europe and slow growth elsewhere. If Chinese economic growth continues to weaken, social unrest in China, where millions have lost jobs, may become a problem. The usual geopolitical risks from Iran, Syria, and elsewhere remain.

Considering these risks against the relatively positive backdrop, one has to put a couple of extra weights on the positive side of the scale to give effect to the role of the central banks. The Federal Reserve has been forthright in its determination to counter the contractionary aftermath of the financial crisis. Last month, it announced a new phase of its so-called quantitative easing, whereby it will buy large amounts of mortgage-related securities. The Fed specifically cited the weak jobs market and its mandate to promote full employment as the basis for this action. Significantly, it did not set a termination date for the buying program. Perhaps more important now even than the Fed is the ECB. Its announcement of unlimited buying of bonds of governments that seek and accept support of the European Union reduced borrowing rates of Spanish and Italian bonds dramatically and reduced fears of chaos. The proposed bond buying is specifically contingent upon a nation's request for funds from the European Union and compliance with the conditions imposed by the EU on government spending and tax policy. Spain is likely to be the first to seek this

By

Jack Mayberry

aid. So far, Spain has not made its formal request, presumably hopeful that it can avoid the certain fiscal strictures that will accompany further funds.

The astonishing thing is that the ECB has not yet taken any action, but only promised contingent bond buying. Yet that contingent promise has been sufficient to defuse the crisis that seemed in June to be on the point of exploding. Shortly after Mario Draghi, the ECB president, began his public discussion of the policy in July, Chairman Bernanke and other Fed members began to discuss the Fed's next round of quantitative easing, which was formally announced and begun in September. The influence of these two central banks is extraordinarily potent, especially in financial markets. Bernanke has made the point more than once that the Fed's monetary policies support asset prices--stocks and bonds--arguing that higher asset prices increase the wealth and the spending of members of the public. This increased spending supports and enhances economic growth, as the argument goes, to the benefit of the job market.

Particularly in the case of the Fed, it is important to distinguish between the possible economic outcome of its radical monetary policy and the effects of that policy on asset markets. The Fed asserts that its monetary policy during and since the financial crisis has directly enhanced economic growth. That is probably true, but it is not at all certain that the current round of buying mortgage-backed securities and keeping short-term rates at essentially zero will cause the economy to grow from this point. Be that as it may, it seems more certain that the Fed's actions will continue to support stock and bond markets, as they have done since the crisis.

It is harder to know whether the ECB's actions--or, more precisely, its promised actions--will continue to have such a soothing effect on the Euro crisis. The markets have given the ECB the benefit of the doubt, encouraged also by the apparent commitment to the preservation of the Euro by the important political leaders in Europe. But the situation in Spain is fraught with terrible problems: overall unemployment is 25% and far higher among the young; Catalonia holds a vote shortly bearing upon its secession from Spain. Despite its best efforts, Spain's debt level will fall far short of the existing targets set by the EU; further fiscal austerity may make things worse. The International Monetary Fund, a lender in the European bailouts, warns ever more forcefully of the dangers of the imposition of such austere fiscal policy. The overwhelming complexity of the Eurozone crisis makes the political, fiscal and economic issues faced by the United States seem almost trivial. (They are not trivial.)

The calm that prevails now has come about because the key central banks have taken exceptional actions and made exceptional promises. (Mario Draghi said in July that "the ECB will do whatever it takes to preserve the euro. And believe me, it will be enough.") The central banks have been the bulwarks in these crises. But what if more is needed from the Fed and the ECB? Central banks can print money, as the saying goes, an in unlimited amounts. How much more unlimited buying of various securities is feasible in the face of strong objection by important political forces in Europe and America? In America, the underlying economy is improving; more novel Fed support may not be needed. In Europe, the economy is weak, but political movement is positive. For now, Core's portfolios tilt toward opportunity, but we are well aware that serious problems remain. We will remain alert.

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