

Dining with the devil

Use a long spoon, and watch the details

September 25, 2009 – Because they make such easy and appealing targets for populist political vote-gathering, bankers became the whipping boys at last week’s G-20 summit in Pittsburgh, PA. As we forecast in these notes, the search for villains in this most recent bout of financial bubble bursting got underway very quickly. It’s no surprise that bankers, their pay packets, and bonuses got put in the stocks this time around, especially after so many of them stepped up to the public trough and drank deeply. It’s said that when you sit down to dine with the devil, be sure to bring a long spoon.

Banks, automobile companies, and other direct recipients of fiscal “stimulus” and “troubled asset relief” programs in the US and elsewhere are quickly learning the truth of that maxim. Indeed, it is becoming increasingly clear through growing real-world data that the fiscal stimulus on both consumer spending and business investment has had close to zero lasting effect on improving gross domestic product. Research is showing that any improvement in the economy through the third quarter has come through the private sector, not as a result of government pork-barrelling but in spite of it.

Companies on the public dole, meanwhile, are learning the old, old lesson about making deals with the devil. “Former CEO” is being added to a growing number of resumes of head honchos who succumbed to the siren song of public bailout funds, at least of those former CEOs who haven’t retired to their estates on Nantucket Island and are still actively looking for work.

Furthermore, stern G-20 resolutions to establish, by the end of 2012, more robust capital ratio guidelines for banks of member nations also makes for great political theatre, but should be taken with a grain of salt. Though multi-lateral political and economic groups like the G-20 have long ago supplanted the United Nations as effective forums for discussion of matters of mutual trade, political and defense interest, their effectiveness and enforcement are just as tightly circumscribed by a host of preexisting domestic priorities and other bi- and multi-lateral agreements.

The most pressing of these is that nations only very reluctantly give up sovereignty over monetary matters. This can be seen in the European Union, where 16 of the 27 EU member states, including France and Germany, uneasily submit their monetary policy to the European Central Bank and use the euro as their unit of currency. For now, the

monetary regime seems to be working, but nationalist tensions are never far from the surface.

In the US, the question of monetary policy appeared on investors' radar screens again last week, with the Federal Reserve Board's decision to keep its key federal funds rate unchanged at between 0% and 0.25%. That announcement had been widely expected and already built into investor expectations. However, the question of when and how the Fed would begin to remove monetary accommodation has become of greater concern now that there are signs the recession has ended.

The nub of the matter is fairly simple. Remove monetary accommodation (that is, the current regime of *really* easy money) too soon, and you risk choking off the economic recovery, which Bank of Canada Governor Mark Carney aptly characterized as "nascent." Leave the printing presses running for too long, however, and you risk a nasty bout of inflation down the road.

While the Fed has decided to pump another \$1.25 trillion into the beleaguered US mortgage market through its purchase of mortgage-backed securities, it announced that some of its bailout and support programs would not be renewed at expiration or would be cut back. Perhaps even more importantly, it also said it would shorten the maturity of loans offered to banks under its Term Auction Facility to 28 days now, and shorten even more early next year. So despite warnings from the likes of the International Monetary Fund about the dangers of removing stimulus too early, it's already happening.

Fed Chairman Ben Bernanke and his Board of Governors have shown just how aggressive they can be in combating financial crisis. There is no reason to believe that they won't be equally aggressive in removing accommodation even before the need for such a move becomes visible to the market. That implies a Fed policy that not only ends quantitative easing but one that also begins to raise interest rates. And that is likely to happen sooner than most observers now expect.

This contributed to last week's weakness in equity markets along with news that US durable goods orders unexpectedly dropped 2.4% in August, while new home sales flattened after four consecutive monthly increases.

The Dow Jones Industrial Average and the S&P 500 Composite index ended a three-week string of advances, closing down 1.6% and 2.2% week-over-week, respectively.

With oil and gold both giving up previous gains, and with Bank of Canada Governor Mark Carney jaw-boning the Canadian dollar down to about \$1.09 from \$1.06 per US dollar the previous Friday, Toronto's benchmark S&P/TSX Composite Index gave up 2% on the week, also ending a three-week string of gains.

While the G-20 political leaders staged a bit of a Punch-and-Judy puppet show for the masses last week, calling in the world's bankers' IOUs for their deals with the devil,

central bankers' attempted to focus on the ever-rising tide of economic detail, where, we are told, the devil is also often said to reside. ■

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