

Reflationary follies

Promise of more monetary stimulus lifts markets

October 8, 2010 – There’s never been a market anywhere, anytime that didn’t revel in the prospect of easy money. And central banks in the US, Japan, the UK, and even to a lesser degree the eurozone, are preparing to attempt round two of a massive reflation in an effort to head off a potential deflationary trend, stimulate flagging economies, and bring down unemployment rates. Trouble is, there’s no reason to believe those efforts will work any more effectively this time than they did 18 months ago. One thing all this stimulus talk has done, however, is to stimulate stock and commodity market rallies, sink the US dollar, rekindle protectionist sentiment, and rile up currency markets.

Judging from recent comments by various regional U.S. Federal Reserve Bank governors, and from a distinctly dovish tone in September’s Fed announcement, another round of quantitative easing appears imminent, possibly as soon as November. “Quantitative easing” is a technocratic term for the process by which central banks buy assets like Treasury bonds, reducing yields and thus loosening the reins on credit, and in effect creating money. The process is used when more traditional tools, like cutting the key central bank lending rate, have been exhausted. (The target for the US federal funds rate continues to rest at zero.)

The Bank of Japan has already commenced a round of bond buying, as a restive electorate demands that the government “do something” about the strengthening yen, which dampens Japan’s export-oriented economy, high unemployment, and slowing economic growth. That “something” turned out to be a round of quantitative easing and policy rates at 0% to 0.1%. The elephant in the room, however, is the country’s massive public debt, which has the potential to raise borrowing costs not too far down the road. That particular debt elephant is making itself at home in the Finance and Treasury departments of governments all around the world, with only a few exceptions. Think Greece, Ireland, Spain, and Portugal, and you get a small taste of the kind of havoc that elephant can wreak. It’s not a pretty sight.

Unfortunately, the world’s largest developed economies are mostly in the same predicament. Huge fiscal deficits from the last attempt at “saving the financial world” from what appeared to be certain ruin has sated electorates’ appetite for any more fiscal stimulus. The new hymnal is entitled “Austerity,” and nervous incumbents are suddenly all singing from the same page. Too late for most of them, though, as long-entrenched governing parties go down to ignominious defeat everywhere.

Yet deep-rooted financial problems persist. Consumers continue to “de-leverage balance sheets” – another technocratic term for paying off debt – instead of borrowing and spending wildly, as puzzled Keynesian economists believe they should be doing in a near-zero interest rate environment. Banks are sitting on stacks of cash, but with no takers. In the US and elsewhere, the banks’ pendulums have swung from “Wild Bill” to “Honest John” in virtually the blink of an eye, as new rules on risk levels and capital ratios kick in. Businesses, too, are sitting on stacks of cash, but are unwilling to expand plant, equipment, staff, or R&D budgets in the face of massively intrusive and troublingly vague financial, healthcare, and environmental legislation forced through Congress by the Obama-led Democrats’ overwhelming majorities.

So it’s left to central banks to flood the market with liquidity in an increasingly desperate effort to get something – anything – going. But as we said at the outset, what’s been going is bond yields (down), commodity prices (up), and emerging market currency valuations (up).

In Canada, it seems increasingly unlikely that the Bank of Canada will add another 25 basis points to its target overnight rate, currently sitting at 1%. That’s because employment, the holy grail of policymakers everywhere, is going nowhere at all. Last week, Statistics Canada’s September employment data showed that overall employment dropped by 6,600 jobs month over month from August. The unemployment rate fell to 8.0% from 8.1% the month before, but only because the so-called “participation rate” slackened – in other words, a lot of people simply stopped looking for jobs, some of those returning to school. All in all over the past three months, the Canadian economy has added only an average 7,000 jobs per month. More worrying is the net job loss in the private sector: some 40,000 jobs lost over the past three months.

In the US, September non-farm payrolls fell 95,000 from August, indicating that the US economy is still a long way from vigorous health. The unemployment rate remained stuck at 9.5%, as government job cuts add to persistent weakness in the private sector.

Against this backdrop, semi-annual meetings of both the International Monetary Fund and the World Bank on the weekend are likely to focus on developing global currency frictions, as emerging, export-dependent nations, including China, attempt to prevent their currencies from appreciating, while the US greenback keeps slip-sliding away. The IMF will attempt to bring some order to the currency conundrum by jaw-boning participants into a unified policy approach. It’s a job akin to herding cats, and is unlikely to yield any immediate positive results. Currency accords designed to revalue global currencies, like the Plaza or Louvre Accords of the 1980s, are difficult to achieve even at the best of times...and these are definitely not the best of times! So look for the currency catfight to continue for some time yet.

Markets weren’t all that fussed about the currency complaints. Instead, the prospect of mountains of fresh liquidity rallied stocks and commodities last week. Spurred by advances in gold (at US\$1,347.90/oz. on Friday), oil (US\$82.84/bbl.), and copper

(US\$378.50/tonne) through the week, the S&P/TSX Composite Index gained 1.4% week-over-week, its fourth consecutive higher weekly close.

Similarly, the Dow Jones Industrial Average advanced 1.6% week-over-week for its six straight higher weekly close, breaking the 11,000 level for the first time since May, while the S&P 500 Composite Index gained 1.7% over the previous week.

A tsunami of monetary stimulus is about to flood financial markets again. That will give support to commodity prices and by extension to Canadian stocks. It will also have the less desirable effect of pumping up the Canadian dollar, not so good for Canadian manufacturers or exporters. Expect rising volatility through October as all markets continue to grapple with the uncertainties of currency revaluation and deepening fiscal turmoil. ■

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