Asset boost

Fed prints money, prices rise

November 5, 2010 – The global asset rally was entirely predictable. In fact, we predicted it right here in these notes about a month ago. So did many other market watchers. Wednesday's announcement by the US central bank – the Federal Reserve Board – that it would create another US$600 billion in fresh liquidity boosted stock and commodity markets around the world to levels last seen just before the collapse of Lehman Bros. Holdings Inc. a little over two years ago. As encouraging manufacturing and employment data added to the renewed sense of optimism last week, investors happily grabbed at just about anything that was offered for sale, including high-grade corporate bonds. But plenty of questions remain about whether the Fed's move will light a fire under economic growth, its stated primary objective, or simply trigger inflationary asset bubbles around the globe.

As telegraphed noisily over the past couple of months, the Fed finally did announce on Wednesday that it would buy $600 billion of US government bonds by mid-2011 in an effort to drive down lending rates, encourage increased borrowing, and stimulate spending to fire up what it terms "disappointingly slow" economic growth. Part and parcel of this strategy is to head off what the Fed sees as an incipient deflationary spiral – a general decline in price levels – of the debilitating kind seen for over a decade in Japan through the 1990s.

However, critics have pointed out that the Fed is sailing into uncharted territory here, in effect financing government spending by purchasing virtually all of the debt issued by the US government over the next eight months. This is known as "monetizing the debt" in the econo-sphere and can lead to rapid rise in inflation somewhere down the road. It also results in a weaker dollar and can lead to the creation of asset bubbles and inflation abroad as the flood of fresh liquidity rushes away from the US Treasury market, seeking higher-growth assets. Last week, for example, emerging market stocks advanced to their highest level in two years, as the MSCI Emerging Markets Index posted a 16% year-to-date gain.

In fact this has been the genesis of much of the currency friction besetting global markets recently, as emerging nations complain bitterly of the effect that the appreciation of *their* currencies is having on their economies, many of which are dependent on exports for economic growth. The rising threat of global protectionist moves still looms large.

Policy interest rates are already poised to rise in emerging Asia to slow the pace of inflation. India's central bank last week raised its benchmark rate for the sixth time this year. China surprised global markets with a rate hike last month. South Korea and the Philippines have been warning of the ramifications of currency appreciation, including the possibility of controls on capital inflows and stricter lending requirements.

In Europe, both the European Central Bank (ECB) and the Bank of England have kept interest rates unchanged. The euro, meanwhile, has gained 19% against the dollar since June, climbing to US$1.42 last week. Contrary to the Fed's moves, the ECB has been removing emergency stimulus, and has no plans to change its policy, according to ECB president Jean-Claude Trichet, speaking at a press conference last week. Ditto for the Bank of England, which kept its original stimulus program unchanged and did not move to purchase more bonds, citing rising inflation and the strongest economic growth in a decade over the past two quarters.

Against this backdrop, then, came some key economic data that bolstered investors' appetite for riskier assets even more than the Fed's monetary goosing did. Specifically, manufacturing indexes around the world gathered momentum in October as new orders and production levels rose everywhere. In the US, for example, the widely followed Institute for Supply Management's (ISM) manufacturing Purchasing Managers Index rose to 56.9 from 54.4 in September. Any reading above 50 indicates growth. The manufacturing lift in October was seen everywhere, from the U.K., to China, to India, to the eurozone. And in the US, the ISM's non-manufacturing index showed that the sector (which actually accounts for 90% of the economy) rose at its fastest clip in three months.

On the employment front, the US economy added 151,000 jobs in October, powered mostly by a gain in private sector employment. The number was considerably more than forecast, even though the unemployment rate remained stuck at 9.6%. That may soon begin to change, however, as US productivity growth slows (2.5% year-over-year in the third quarter, compared with 6.3% in the first), implying that productivity gains have peaked and that companies are now poised to hire more workers to maintain and increase output. In Canada, a small net gain of 3,000 new jobs was actually powered by underlying strength in the private-sector, where 47,000 new jobs were added to payrolls.

The Fed's new round of money printing, on top of slowly-but-surely improving economic data, was enough to spur a jump in the Reuters Jeffries/CRB Commodity Index to 314, its highest level since October 2008. The prices of most commodities, both "hard" (raw materials like metals and oil) and "soft" (foodstuffs, textiles) have been on a tear for the past few months. The combination of a falling US dollar and increasing investment demand has pushed the price of gold to new highs near US$1,400 per ounce. Copper and other base metals have followed suit, owing to growing demand from China. Foodstuffs like sugar, coffee, and cocoa, and textiles, like cotton, have also staged strong rallies, again because of a combination of the falling US dollar and supply imbalances brought about by lower crop yields and export restrictions in many producing regions.

Of course, none of this happens in a vacuum. And so consumers are beginning to see rising prices for everything from their daily Tim's double-double or Starbucks *latté* to t-shirts, dress shirts, socks, and jeans. Is that "inflationary"? It is insofar as the tidal wave of US dollars keeps downside pressure on the greenback (and never fear, it will, it will). So Fed Chairman Ben Bernanke and his band of monetizing governors will see their fondest wish for reflation come true, but perhaps not in quite the way they expect.

Meanwhile, stock markets, riding a tide of higher third-quarter earnings reports and the promise of another year of cheap, cheap money, powered to weekly gains again last week. Toronto's S&P/TSX Composite Index advanced 2% on the week, as the commodity rally boosted resources, overcoming the negative effects on Canada's exports from the loonie's near-parity with the fading greenback.

The Dow Jones Industrial Average gained 2.9% week over week, while the S&P 500 Composite Index powered to a 3.6% weekly advance.

Even if the Law of Unintended Consequences kicks in for Mr. Bernanke and Co., as we wrote in our notes at the beginning of October, "One thing all of 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." We see no compelling reason to revise those views at this time.■

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