

US Fed readies the presses

Gold climbs to record high

September 24, 2010 – Is inflation “too low”? The US Federal Reserve Board seems to think so. And with its hold-the-line rate announcement last week, it also laid the groundwork to resume purchases of Treasury bills and mortgages if the economic recovery continues to lag. Only one of the eight governors continued to express concerns about the potential for a build-up of latent inflationary pressure down the road. Many investors appeared to side with the Fed on the greater proximate danger of deflation, abandoning the US dollar and buying gold with renewed vigor, raising the spot price to a record high near US\$1,300 per ounce. Stock markets, meanwhile, remained undecided, gyrating through a week of triple-digit moves before advancing to higher ground.

As economic data increasingly tell a story of a faltering recovery, the US Fed last week signaled its willingness to resume a program of quantitative easing, saying it would “provide additional accommodation if needed” to keep the wheels from coming off the recovery.

And in what appeared to be an unprecedented statement, it also said essentially that the level of inflation is below what it thinks is consistent “with its mandate to promote maximum employment and price stability.” It went on to say that it is “prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its [the Fed’s] mandate.” It’s highly unusual for the Fed to mention an inflation target, because, unlike Canada and other central banks, the Fed does not overtly set a desired level of inflation, instead using its personal consumption expenditures price deflator as only one of many tools to set monetary policy.

The big problem is that after a thrilling first-quarter rebound in economic activity, driven by massive government spending and record-setting budget deficits, the pace of recovery has slowed to a snail’s pace. Consumers remain intent on de-leveraging after a decade-long binge of government-mandated easy credit, and nothing, it appears, will stimulate them to resume borrowing or banks to resume lending at anything like pre-recession levels, not even the Fed’s renewed pledge to keep its federal funds rate at “exceptionally low levels...for an extended period.” The US housing market continues to languish, while unemployment remains locked at a stubbornly high 9.6%.

Meanwhile, the National Bureau of Economic Research, a council of economic deep thinkers, declared that the 18-month US recession, longest since the Second World War,

officially ended in June 2009. This means only that the contraction in economic activity ended. It made no comment about the strength or weakness of the recovery since then, saying only that “economic activity is typically below normal in the early stages of an expansion, and it sometimes remains so well into the expansion.” It may be that this key insight has been overlooked with all the current hand-wringing about the sluggish recovery, the current low rate of inflation, and the high rate of unemployment.

The Fed’s statements have kept Treasury trading volatile as investors continue to speculate on the timing of a resumption of bond buying by the Fed. Speculation on potentially falling long-term yields has rallied prices of 10-year Treasury notes, pushing yields down to a recent 2.6%.

In Canada, consumer price readings for August suggest that the Bank of Canada, too, may reconsider pulling the trigger on another rate hike in October. August’s all-items consumer price index fell 0.1% month over month, for a year-over-year rate of 1.7%, down from 1.8% in July. The core rate, which excludes volatile items like food and energy, remained unchanged year-over-year, at 1.6%. The inflation readings are coming in below the BoC’s own projections for the third quarter, at 2.1% for the all-items CPI and 1.8% for the core index, causing a rethink in the econo-sphere about the firmness of the BoC’s plans for another 25 basis-point rate hike at its next meeting.

As the US recovery gets more sluggish, Canada’s economy will unavoidably feel the effects. Everything from a slowing housing market to slowing consumer credit and a cooling labor market (as public-sector and construction job creation slow) are conspiring to slow the growth of Canada’s recovery as well.

Global growth, too, is cooling, as the heady rush of stimulus spending begins to fade. Emerging markets like India, China, and Brazil continue to show positive economic growth, though perhaps not at quite the blistering pace seen through the first three quarters of 2010. European growth remains hampered by a weak labour market and commensurately soft consumer demand. The 1% GDP reading for the eurozone in the second quarter is likely to fade in the third, as ongoing fiscal austerity measures are continue to weigh on both consumer and business confidence.

Still, stock markets edged up on the week having already discounted much of the negative macroeconomic readings, as US blue chips advanced broadly on Friday following a positive report on durable goods orders. Canadian stocks broke even, with the support of firming resource prices as gold climbed to a record high.

The S&P/TSX Composite Index eked out a hair’s-breadth gain of just 0.3% week over week. But the Dow Jones Industrial Average advanced 2.4% on the week, for a fourth consecutive weekly gain, and is ahead 8% on the month so far. Likewise, the S&P 500 Composite Index rallied for the fourth consecutive week, posting a 2.1% advance on the week. Implied volatility, meanwhile, continued to ebb, as the CBOE Volatility Index (VIX) closed the week below 22, while volumes have started to pick up again. October, the month of market surprises, is almost upon us.■

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