

## Hot air settles markets

*Bernanke says nothing much, markets relax*

*August 26, 2011* – As Hurricane Irene bore down on the eastern seaboard of the U.S., another variety of hot air blew out of a place called Jackson Hole, Wyoming. That’s where assorted central bankers and economic deep thinkers meet every year for a gabfest to exchange ideas and dine on the proverbial rubber chicken. The Chairman of the US Federal Reserve Board, Ben Bernanke, traditionally makes a speech outlining the Fed’s views on the economy, monetary policy, interest rates, and so forth. And the effect of his speech on markets this year was more in the anticipation than in the consummation.

That’s because Bernanke didn’t say much of anything. Certainly nothing that he has not been telegraphing for some weeks. Still, he gave stocks markets some measure of relief, after another trying week of giddy ups and downs on weak manufacturing reports from various regions in the US, mixed signals from the durable goods report for July, an uptick in new claims for unemployment benefits, and the continuing crisis in the eurozone. And, oh yes, anticipation of what Bernanke would say, with plenty of speculation about the contents of the Fed’s fabled “quiver,” whether or not another round of quantitative easing is imminent, even whether the Fed is any longer capable of meaningfully affecting the course of events, given that the first two rounds of quantitative easing have been progressively less effective, and its benchmark federal funds rate is already at zero.

No matter. Investors seemed to breathe a bit easier on Friday after Bernanke’s speech, which was innocuous, to say the least. He essentially reiterated that the economic recovery isn’t as strong as everyone had hoped it would be. He said, “The growth fundamentals of the United States do not appear to have been permanently altered by the shocks of the past four years,” and added that “economic healing will take awhile, and there may be setbacks along the way.” To that, we add, see our comments about hot air in the first paragraph.

Perhaps of more interest were remarks by Thomas Hoenig, the president of the Kansas City Federal Reserve Bank, at the same confab. In a television interview, Hoenig said, “I don’t see a double-dip recession.” Hoenig, of course, is part of the Fed’s minority opposition on some key matters of monetary policy, especially the essential looseness thereof. And he has also been a vocal critic of allowing banks to become “too big to fail” in the first place. So if Hoenig basically agrees with Bernanke on the question of a double-dip recession, he’s probably worth listening to.

Second-quarter U.S. gross domestic product (the economy, in other words) grew at an annual rate of only 1%, dragged down by slowing exports and some foot-dragging by businesses in the inventory restocking department. Both consumer and business spending, however, were higher in the quarter, suggesting more impetus for growth in the third quarter of the year. To that extent, at least, the news was less bad than it has been over the past couple of weeks, or at least was perceived thus.

In the too-big-to-fail department, Warren Buffett – investor, financier, taxpayer, one of the world’s wealthiest men, and now lender of last resort – called on one of America’s biggest banks last week, and offered to bail it out. Bank of America happily accepted. Amid much tut-tutting and pooh-poohing that even the very thought that BoA even remotely needed a capital injection to forestall continuing losses from bad mortgages was absurd, the sweaty bankers fairly tripped over each other in accepting Buffett’s offer to buy US\$5 billion in BoA preferred stock with a rich 6% yield and redeemable at a 5% premium. And incidentally, as a kicker, he also gets enough 10-year warrants to buy 700 million common shares at US\$7.14 per share.

If it all sounds familiar, it’s because Buffett organized the same kind of golden parachute when he bailed out Goldman Sachs Group and propped up General Electric Co. back in 2008. While cushioning those companies from the results of their unfortunately bad investment decisions, Buffett also made a couple of astute investments on his terms, and reaped billions in profits when his investments were later redeemed. The same endgame will play out with Bank of America. He’s already up over a billion on the deal. No wonder Buffett looks like the cat who just swallowed the canary, followed by an entire pint of rich cream.

Gold, everyone’s favorite precious metal, meanwhile ended the week down from its record high of US\$1,917.90 per ounce last Tuesday. December futures contracts closed the week at US\$1,797.30 per ounce, down 5% in the past week, as gold posted its first weekly loss in eight weeks. In after-hours trading, though, it had climbed back up to US\$1,823. So while there were predictions aplenty that gold was ready for a serious blowoff, the ultimate store of value continues to defy expectations.

The eurozone, after all, still hasn’t resolved any of its problems as member nations bicker over such things as “collateral” for bailout loans to Greece et al. Eurozone growth is flagging, expanding only 0.7% in the second quarter. The US still has a massive and as yet unresolved budget deficit problem (not to be confused with the recent “debt ceiling crisis,” which was resolved, after a fashion), while China grumbles about its appreciating yuan and builds stealth jets and aircraft carriers. All of that, and more, is likely to put a pretty solid floor under gold for the foreseeable future.

Equity markets also rallied on the week, as volatility began to settle down. The S&P/TSX Composite Index advanced 2.7% on the week, held back by disappointing third-quarter results from Royal Bank of Canada, which weighed on the entire financial sector.

In New York, however, markets advanced strongly, as the Dow Jones Industrial Average climbed 4.3% on the week and the S&P 500 Composite Index rallied to a 4.7% gain on a strong comeback in the technology sector.

And, oh yes, that volatility? After spiking to over 48 in early August, the CBOE Volatility Index (VIX) closed last week at just over 35. Seems nervous investors aren't quite as willing to place a high premium on options as insurance, suggesting that perhaps some of that extreme fear is beginning to dissipate from the market. Still, any sustained reading above 30 bears close watching. ■

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