31 JANUARY, 2011

Between monetary policies

Where are markets heading to?

Mutual relations, which characterize markets (to others these may be economic aggregates) allow us to define likely tendencies in specific areas. Firms use these to make strategic decisions regarding the scale and place of production/provision of services, way of financing, the way settlements with clients are done, the costs of introducing new products to the market etc. Investment banks and funds by the following defined steps and by making their own assessments allocate both their own investments and those entrusted to them.

When markets become alike as far as a particular criterion is concerned, analysts try to differentiate between them by applying other criteria. Some concepts are more accurate than others. In short, this is the way one can define the nature of the markets, where besides an economically-desirable direction, the essence of their performance lies in their very movement, even if this involves spinning round in a circle or chasing one's own tail. Markets do not take on an ideal shape, similar to the way a drop of liquid minimalises the resistance of air.

What scenario will govern markets in 2011?

If we look for determining factors, then we should focus on places which already decide or will decide about the specifics of concrete markets. The characteristic features of markets are the original cause of "economic motion" in the form of mutual reactions and the resulting trends. Therefore, what is the key issue in the main markets specifics from the point of view of forecasted performance on the stock exchanges?

My answer is as follows: **The high debt of the United States – in relation to GDP and as a nominal size of debt, as well as the high share of non-residents financing the American economy, is the overriding and determining factor for capital and financial markets.**

One thing we can be sure of, the U.S. will not go bankrupt. In the event there is a shortage of those willing to finance the American economy, the FED will print the missing amount of money. If China, Japan, oil-exporting countries and other countries, as well as banks, funds and other entities and persons, do not purchase the treasury securities at the interest rate expected by the U.S. government then they will depreciate what they already hold. Large US creditors are therefore faced with a serious problem. Firstly, they have no voice, since it is the U.S. government and the FED who are dealing the cards.
Creditors acquired the treasury papers for hard earned cash, whilst it turns out that they have securities which the U.S. government can print off in any quantities it chooses to, without having to worry whether anyone will be willing to purchase them, since it is always when government prints their bonds, the FED can as easily start printing paper using virtual green dye.

The concern of lenders that they may be holding junk bonds is indeed justified. They are not junk bonds because they may fail to be bought up, but because of the risk of the depreciation of the dollar. It may be more appropriate to speak about the risk of "junk dollars" instead of junk bonds.

Is this a worry for the USA, however? After all, everyone would like to get rid of their debt painlessly and special circumstances – for what ever could be considered the crisis, global and found once in 100 years – excuse the application of unconventional solutions. It can turn out that even with the good will of the U.S. government, the printing of junk money in a quantity causing a significant depreciation of American currency and high inflation cannot be avoided.

Inflation is the ultimate tool for governments to get rid of a debt burden denominated in national currency. The United States are one of those rare countries, whose debt is almost entirely denominated in their own currency. If the U.S. government with the FED have an instrument in the form of inflation and control over the interest rates, which enables them to get rid of public debt in a very convenient way, so there must be a second side of the coin – bodies who would pay for this operation. They would be not only the holders of US Treasury securities, but all holders of deposits, bonds and other debt assets denominated in the US dollar. On the other hand, the beneficiaries of such operation would include not only the U.S. government, but all debtors having debt denominated in the US currency, in particular, the majority of American companies and households.

How should the balance of profits and loss of the „junk money" operation be assessed from the point of view of the U.S. regarded as a whole, i.e. the government, American citizens and firms? A good answer is one which takes into account the scale and the structure of investments in American assets made by foreign investors, as well as American investors in foreign assets.

The value of debt of American residents is four-time higher than the value of debt-assets lent by them to foreigners. Even assuming that the inflation processes initiated by USA will migrate over to other countries, then it can be clearly seen that the "get rid of debt by inflation" operation will benefit Americans and the foreigners will lose out, for example, China, Japan, oil-exporting countries etc.

The structure of investment in EQUITY and FDI (foreign direct investment) split between US-residents and foreign investors is equally valid. The Americans have invested over 8,000 billion USD in such assets abroad, whilst foreigners hold 4,700 billion of such investments in the U.S.

Foreign-owned US assets and US-owned foreign assets (2010 Q1) in billions USD

	Foreign-owned US assets	US-owned foreign assets
Debt	7933.9	2084.2
Equity	2774.4[A]	4157.3
FDI	2030.9	3990.2
Other	2086.1	1283.7
Total	15625.3	11515.4

[A] Includes corporate equity plus mutual fund shares

Source: Federal Reserve (2010-06-10). "Flow of Funds report". p. L.107.

Investments in EQUITY and FDI are resistant to the printing of worthless money. They have their ’real’ value. Should the value of money drop, then the value of such assets as EQUITY, FDI, would nominally increase in a declining currency.

One can risk the statement that from the point of view of the real value of companies’ shares inflation is indifferent. Of course, there are all sorts of businesses, with a different scale and structure of debt, different cash flow, assets, etc., where monetary policy and inflationary processes directly affect the value of particular firms. Looking statistically at companies as a whole, their value as expressed in dwindling currency will increase.

Since printing junk money pays America then a real threat arises for the rest of the world. An investor analyzing markets may assume that it is the last call to take up a short position on the dollar. However, the question remains: what is this short position is to be taken against? Will potential inflationary processes drive the downward spiral of damaging other currencies? Are countries going to compete in a plebiscite of who has the weakest currency?

It would appear that spoiling own currency does not lie in each country’s interest.
Germany may serve as an example here. Companies, and primarily German households, prefer traditional saving methods, such as bank deposits and bonds. German pension funds also tend to invest a small proportion of their investments in shares and acquire mostly government bonds, corporate bonds, and also hold bank deposits. Next to the structure of the investment of German residents, an equally significant factor is the high propensity for saving amongst German households against the synonym of Americans living on borrowed money.

Another factor, which is, however, disproportionally less significant than the two mentioned earlier, is lower total public debt in relation to GDP in Germany than in the United States – approx. 85% and 95%, respectively.
The global benefit of Germans – citizens, corporations and government – is linked to retaining value by EURO and indeed, such is the strategic objective of German policy.

Whilst viewing the determining factors of the US monetary policy and German’s, the first conclusion which springs to mind relates to the probable increase of the value of the EURO versus the Dollar.
Reality, however, may be more complicated than that. The way the European Union functions is an overriding complication as it becomes a bureaucratic body managed to suit hasty political interests. The resulting economic decisions made by companies and clerks do not lead to the effective allocation of capital.

Due to high share of subsidies, companies must take into account any bureaucratic factors. Non-market behaviours within the EU economy increase each year, civil servants turn to managers, who suddenly decide about the direction of investments, whilst company managers fill out questionnaires in the hope of obtaining subsidies. In a situation where a marginal factor decide about the markets competitiveness such weight drags the European economy – if not into an abyss, than into muddy waters and swamps, in which successive countries, often ex-darlings of union policies, drown.

It turns out that Germany's desire to keep the EUR strong may not be sufficient. The weakness of the European currency must thus by no means result from the creation of junk money, only because the structure of the increasingly socialist European economy is a sufficient contributory factor.

Will the EUR/USD rate be outweighed by EU economy or US monetary policy?

Referring back to the U.S.

At this point one needs to refer once again to the strategic intentions of the U.S. government. What may oppose the concept of easily defeating debt by creating high inflation or at least maintaining negative real interest rates?

The creation of junk money is, in the literal sense of the word, equivalent to stealing from creditors. The countries which posses US Treasury securities may by way of recompense impose sanctions against American investments or, as a final measure, take over assets belonging to US bodies. This, of course, would be an extreme reaction, one placing international relations on the warpath, but in the case of the US printing false money, may constitute a justified reaction of country-creditors who hold the dollar bills, notes and bonds.

There is also a domestic factor, which forms a certain barrier against printing money. Reasonable Americans were punished by their own government, those who have seen a speculative spiral trend did not borrow beyond their means. Those investors, who were intending to acquire assets following the return of realistic valuations, were cheated.

At the time of stock exchange drops, the FED boss, Ben Bernanke, said to his colleagues:
Buy everything, I shall give you so much money that you will be able to do so. You can get as much as you want. Later, when assets get dearer, you will make dozens of percents whilst you give back a mere few percent, at around the nominal value. We shall declare this program as our joint success.

In this way the pockets of Ben Bernanke's colleagues were filled up risk-free and more rapidly than during the previous boom.
Instead of allocating assets by market forces, where the discounted shares and equities would be acquired by those investors, who know how to multiply money, creating added value in the process, they ended up with individuals who had caused the crises in the first place and who were indeed creative, but within the area of creative accounting.

Ben Barnanke's policy is not only dishonest, but is also harmful to market mechanisms.
It transpires that the crises had benefited mostly those who provoked it, since at a time when money was king they were awarded shopping money. The recipe provided by Ben Bernanke to Americans is dishonest and wrecks business relations. It was not effective performance, but getting into privileged circles guaranteed the highest and fastest-growing profits. Since we have a notion of just and fair value, perhaps one should introduce the notion of "unfair profits", which manifested themselves in billions of dollars being handed over to selected bankers, so they could buy themselves depreciated assets.

Instead of handing out money to the creators of the crisis, if anything, it should be given out to all Americans as an extra bonus. A bonus spread over a dozen or so months, even a few years, taking into account economic cycles, which would be known not only to the government but also to companies and consumers. The participants in the market would then be able to align themselves with the expected supply of money and discount the future shape of the market. It would be a quasi-market mechanism of fighting a crises, where the economic decisions of millions of people would determine the shape of the market and the situation of companies. The government's role would be to guarantee the solvency of the financial system; instead we were witnessing the subsidizing of financial entities to rescue their owners from making losses.

State guarantees could cover for example 90-100% of deposits held by natural persons, 80-90% held by companies and 70-80% of interbank deposits. A certain level of responsibility amongst deposit holders is necessary, otherwise the system would be ineffective: the greater one's own responsibility, the greater the amounts held, and the more qualified the market participants.

Those financial bodies, which would fail to perform successfully despite the influx of money to the market, should go under while their liabilities should be taken over largely by the government. The weakest parties would disappear from the market or would be taken over by other better-coping companies. This solution would benefit the effective functioning of markets, but would not necessarily assist bank owners. The U.S. government, instead of allocating the money to ensure the liquidity of the banking system by way of a guarantee, supported private bank owners by transferring subsidies to them. As a result, American taxpayers have generously bestowed wealth on the creators of the crisis. A solution both uneconomical and unjust, and one which benefits a small privileged group of people.

Unfortunately, it was not market methods, but connections and relations which dominated the solutions at the time of a large economic cycle change. There is always a chance that the voice of common sense, including the voice of the American society, rising in volume, as it learns the ins and outs of fake repairs to the economy, would counteract the money-wrecking policy.

Summarizing the above, I consider that the more probable outcome is the fall of the US Dollar against the EURO.

Hard factors behind the printing of extra empty money shall be counteracted by voices of common sense expressed by the importance of long-term market mechanisms, including the honesty and allocation of assets dictated by effectiveness.

However, as far as the possibility of applying persuasion on the global arena as well as towards its own citizens, the U.S. government will try different styles of injecting dollars, irrelevant of whether it does it in compliance with the rules of effectiveness or against them, simply to get the economy rolling.

The current way of dealing with emerging out of the recession includes factors, which determined the time and scale of another stock exchange crash, one which Ben Bernanke should remember

Once again about Europe,
the economic situation of the EU will counteract the appreciation of the EURO. Despite the fact that it is more likely than the dollar will fall in relation to the EURO than not, I believe that it is somewhat a risky scenario for one of main investment strategy, but for a further deal it is quite proper to take a long-term short position on the US Dollar. In accordance with the principle that there are no above-average risk-free profits.

I consider as one of much less risky level an investment strategy based on buying shares of American companies against shares of European companies.
(but it may prove to be less profitable than a short position on the US Dollar)

Let us consider two possible variants:

Variant One: The Americans start printing bonds and Dollars at full speed.
The result is that the price of assets, including shares, grow in accordance with inflation expectations. Should Europe join the race for the large-scale devaluation of their money (which I rather doubt) they will be one step behind as far as the scale of operation undertaken.

One subordinated version of this scenario may be a substantial fall of the Dollar to the EURO, should Europe refrain from wrecking its own currency in a similar dimension. I consider that in the final result of this scenario the American shares turn up as better investment (despite Dollar devaluation) than European shares. Print out of Dollars will boost American economy, the cost of which will be paid by other countries, not only China, Japan but also Germany. In addition, the European economy with its increasingly socialist burden and highly diversified problems in the Euro zone will not be able to cope in the surrounding market environment, while the changes in the high inflationary market situation would happen fast and be of high gravity.

A second subversion (in my opinion rather unlikely) assumes that Europe will keep up with ruining its own currency and take part in the race for the weakest money. Germany as a nation would suffer a great loss. Many years of German savings would vanish from accounts, German firms and natural persons with their investment structure, assume that the loans they have given will be paid off in strong money. The conservatism of German citizens lies in making deposits in their own currency, therefore the German banking system, which met the requirements of balanced currency positions, extended loans mainly in the Euro or entered into transactions by securing a swap for loans in foreign currencies. As a result, Germany's banking system also has no interest in ruining the Euro, in addition to which it has investments that originate from domestic banks' own capital and are also tied up to the value of the European currency.

The scenario for wrecking the Euro would mean that Germans choose at free will to lose their savings accrued over multiple years; both by natural persons and companies. It would mean sliding down for German economy. Germans would hand over their riches to other nations - to those who live more on credit or to those who have a different investment structure and in particular the ones leveraged purchase of shares and other equities.

Such unreasonable behaviour would be like an earthquake for the German economy. In real terms, devaluation of the Dollar and Euro in a similar dimension would lead to American companies becoming stronger against German companies. I consider that such scenario would cause utmost disparity – America would simply siphon out the riches resulting from German savings.

Variant Two: The second scenario involves Americans tightening their belts.
One can hardly expect the resulting stock exchanges to rise in such a case. The expected drop in American shares should, however, be smaller than that in European shares.

As a result of a lack of pro-inflationary US policy, Europe is saved from the drop in values in real terms of the Dollar denominated debt papers. On the other hand, there will be no impulse to change the economic situation originating from the American markets.
Tightening belts would serve the rise in efficiency of American companies, in itself a certain value, which would positively manifest itself in limiting the expected falls in the values of shares of American companies.

To summarize both variants, I believe that the ineffectiveness of the European economy will be more visible at the time of coming out of the crises or during its extended period then at the final phase of market break-down. The key element here is the bureaucratized model of running European markets, where politicians and civil servants instead of managers decide about the allocation of capital.
The investment structure of Euro residents acts as a certain stabilizer during the fall of the economy, but becomes a disproportionately larger burden during phase of coming out of the crises, as compared to investment structure of US residents.

I would choose for one of the key investment items the purchase of American companies leveraged against shares of European companies. Regardless of whether markets will rise or drop, such a strategy enjoys fairly decent foundations.
Also because that a nominal change of a given investment has fundamental meaning in the Futures markets, the currency exchange rate for leveraged investments is an important factor, which must be taken into account, although the exchange rate of financial instruments is predominantly the most important aspect.

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