

Global stock markets have enjoyed a central bank-induced rally since mid-December, when the European Central Bank (ECB) implemented its *Long Term Refinancing Operation (LTRO)*. The LTRO, which is the functional equivalent of the Federal Reserve's *quantitative easing* programs, provides three-year funding to European banks at a below-market rate of 1%. As a result of the LTRO and its direct purchases of government debt, the ECB's balance sheet has increased 44% in the past six months to a current size is \$2.7 trillion, which is nearly as large as the Fed's \$2.9 trillion balance sheet and larger than the Fed's balance sheet relative to the size of the Euro economy.

The LTRO marked an inflection point in the financial markets, which have been in "risk-on" mode ever since. The monetization program reduced, or at least postponed, the risk of contagion rippling through the global banking system. Markets went from discounting a crisis to now discounting no crisis.

In addition to recapitalizing the banks with cheap, three-year funding, the purpose of the LTRO is for European banks to use the 1% ECB loans to finance European government debt markets, and allow governments to roll \$1 trillion of debt in 2012. That in fact has happened, as reflected in the sharp drop in bond yields (both short and long term) of the critical European governments that were under pressure in the fourth quarter of 2011. Italian 10-year bond yields have fallen from a late-November high of 7.5% to 5.6% today. Spanish 2-year yields have fallen from 6.2% to 2.6%.

The LTRO program highlights the interdependence of banks and over-indebted governments, and the degree to which both are dependent on central bank support (a situation that is no different in the U.S.) The LTRO has furnished an indeterminate length of time for governments to implement fiscal and economic reforms.

Although overbought in the short-term, the trend in stock markets is clearly up and a test of the 2011 highs in the S&P 500 appears likely in the weeks ahead (see chart below). A consequence of the strong recent rally in stocks, however, is that from an intermediate-term perspective (i.e. looking out over the next six to twelve months), the risk/reward no longer appears very attractive.

Market Comment



Absolute (as opposed to relative) stock market valuations are uninspiring; the economy is probably weaker than the consensus now assumes; and investor sentiment is rapidly becoming overly bullish for the environment we have. Last Friday's ostensibly strong employment report was probably a statistical anomaly due to seasonal adjustments made by the Bureau of Labor Statistics. A composite of sentiment indicators we track from several advisor and investor surveys has moved to a bullish extreme, and the VIX index, which measures expected volatility, reflects a high degree of complacency (see chart below). When this occurs, we should be concerned that too many investors are expecting higher prices, have likely already bought, and therefore support for further prices gains is minimal. Rather than adding risk to portfolios at this juncture, I believe we have entered a period where it makes more sense to begin to trim risk, prune positions no longer deemed attractive, and build some liquidity in order to be better positioned to capitalize on opportunities down the road.



In its January 25th monetary policy statement, and subsequent press conference, the Federal Reserve moved further to the uncharted extremes of monetary policy. The Fed, in its official statement, essentially pre-committed to near-zero rates through late 2014, and Fed Chairman Bernanke, in his post-meeting press conference, signaled an intention to engage in further quantitative easing (money printing) in the event of renewed economic weakness.

Central bank policy, at home and abroad, is deserving of a “rant”. To that end, I offer a selection of recent comments about this very important issue from several analysts I follow:

Doug Noland, Editor of the Credit Bubble Bulletin

“While I was chronicling the emergence of the mortgage finance bubble back in 2002, Fed Governor Bernanke was crafting the Fed’s case for novel reflationary policymaking. Mortgage credit was already expanding at double-digit rates when Dr. Bernanke introduced his intellectual basis for the government printing press. The subsequent decade, replete with a historic credit boom and bust, has seen radical monetary policy doctrine become the mainstream. But didn’t the policy experiment fail miserably? Accommodating gross mortgage credit excesses in the name of system reflation is one of the greatest blunders ever committed in monetary management. The Fed has not been held accountable – either in terms of a seriously flawed analytical framework or the associated policy mistakes. Instead, the Bernanke Fed has become only more radical and domineering in the markets. Public confidence and trust in the Federal Reserve have suffered mightily, yet this has thus far had no impact. Importantly, the power players in political circles and the securities markets have benefited tremendously, ensuring ongoing support for the Fed’s controversial reflationary policy course. The financial mania has reached the point where the completely unreasonable is accepted as perfectly reasonable. It has reached the point where the Fed (along with fellow global central banks) has completely abrogated the market pricing mechanism - and with it the capacity for the self-regulation of debt issuance through higher borrowing costs.”

Bill Gross. PIMCO

“Reflation has been successful but the Fed has gone too far. I would have stopped cutting interest rates at 1% before we got to zero-percent money. The result is financial repression, which means central banks keep interest rates far below inflation. Typically the fed-funds rate was close to nominal GDP. Now it is three or four percentage points below it, which means savers are getting robbed of the 2%, 3% or 4% yield they used to think was destined for their pockets.”

Rob Arnott, Founder of Research Affiliates

“Basically what we have right now is the major developed economy centers are all pursuing a process of cranking the printing press in order to suppress natural market response and natural market interest rates. It represents a powerful distortion for the capital markets. It represents a powerful impetus for people to do one of two things, take risks they might not otherwise have been willing to take, creating the risk-on trade. Or two, to take their money off the table altogether. Think of gold as an example, it’s a way of taking money out of circulation. So when we see gold soaring, what that’s telling you is one of two things. Either the value of the currency is being debased or it means that people are frightened by the government policies and they are pulling money out of the productive economy. Both of those, of course, are bad news.”

John Hussman, Hussman Funds

“My impression is that the recent stabilization is owed to a large extent to various central bank actions. The ECB now has a larger balance sheet - relative to European GDP - than the Federal Reserve has relative to US GDP. It is shortsighted to view the actions of the Fed and the ECB as costless, because the difficult question comes later - whether they will be able to reverse their actions and shrink their balance sheets without major economic disruption. This will require the financial assets they presently hold (sovereign debt and mortgage securities) to be willingly absorbed back by the private sector. From my perspective, central banks are playing a dangerous economic experiment, that has its main constituency - the banking sector - as the primary beneficiary. Of course, if the Fed and the ECB are unable to reverse these transactions, or if any of the assets they hold lose value for any reason, they will ultimately have printed enormous volumes of currency.

Marc Faber, Investment Analyst and Barron’s Roundtable Member

“Zero interest rates force everybody to be a speculator because you're not earning anything on your money. Volatility won't disappear anytime soon, because it has everything to do with excessive liquidity that is being created in the system. It drives the small investor away from the market. He doesn't understand it. He doesn't trust Wall Street, and rightly so. We are trying to solve the crisis created by excessive debt growth and excessive leverage with even more credit and leverage, which will just postpone the problem.”

Lacy Hunt, Hoisington Investment Management

“Two rounds of quantitative easing have raised inflation, but the pace of economic growth did not respond and the standard of living of U.S. citizens fell. In both these actions, moderate income households fared the worst, thereby aggravating the divide between the upper and lower income categories. Some have advocated another round of quantitative easing under the assumption that in some unspecified way it might work better than the two previous failed efforts. However, QE3 has actually begun, in stealth form, via the European bailout. Since this program was announced, the price of oil and some other commodities has risen, bringing along the risk of a further drop in the real income of consumers. The unintended negative consequences of Federal Reserve actions appear to be continuing. Any other balance sheet expansion activities, such as the additional purchases of mortgage-backed securities, will also fail to result in positive GDP expansion. On the contrary, the uncertainty created by untested Fed interventions will inhibit business planning, thereby slowing growth.”

Bill Fleckenstein, Fleckenstein Capital

“My motto has always been: in a social democracy with a paper currency, all roads lead to inflation. It remains to be seen if Europe can avoid a banking system collapse precipitated by governments being unable to roll their debt. But, if enough money is printed by the ECB, then I think Europe will skinny on by. And, if we are finally at that inflection point, the world will then slowly begin to concern itself with stagflation and inflation, and eventually the world's bond markets will start to demand more in interest rate compensation due to real rates being negative. No one will accept negative real rates if they are no longer worried about a deflationary collapse and just getting their money back. I believe we are approaching (if not at) that inflection point, and that deflation is about to become very old news until some time down the road, potentially when the printing press is taken away from the central banks. Obviously, in a world without money printing, we could eventually see deflation. But that would be good news. After all, deflation occurs when prices of goods and services decline, and who is against that? Unfortunately, deflation has come to mean the economic environment of the 1930s, thus people are terribly confused about what the word actually means.”

Jim Rogers, Investor

“The zero interest rate policy is a disaster for most people in the world. You are destroying a class of people who save, and if you do that you build up huge problems for the future.”