"By the Way"

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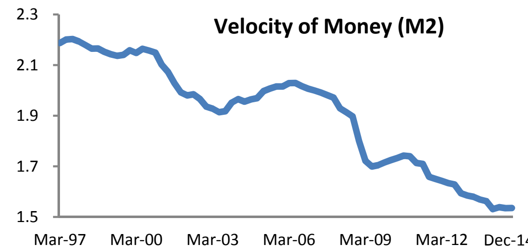
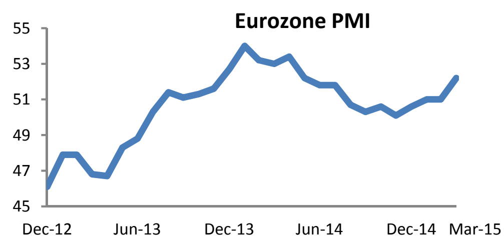
Ben Bernanke has a blog. It is somewhat of a surprise, but we appreciate the former chairman of the Federal Reserve Board sharing his wisdom with the great unwashed. Seriously though, it is an interesting window into how and why policy is formed by that body. (Search Bernanke's name or go to the Brookings Institute website if you care) Given the market volatility that results from any and all proclamations or musings by the Central Bankers of the world, (in particular the Fed) such insights are worthy of our attention. While much of the blog can be tedious and academic, perhaps the most revealing aspect for me is the scholarly method the Fed uses to form policy. There is great dependence on economic theory to produce an "if we do this then that will happen" approach. It is perhaps the only way to form policy, but as we have all learned the world does not always respond in the way the economists expect or hope. Mr. Bernanke defends his actions through a debate on economic theory without seeming to acknowledge the realities of their outcomes in the real world. A simple example is reflected in the results produced by "quantitative easing" and low interest rates when participants in the economy choose not to make productive use of the excess liquidity in the system. The chart of the "Velocity of Money" proves the old adage "you can lead a horse to water but you can't make him drink". This would explain the less robust than expected US economic growth of the last few years, given the magnitude of monetary easing. We are at the mercy of a not necessarily rigid set of assumptions and expectations that are forming monetary policy. The point would be moot if not for the fact that while the effect on the economy is questionable, the effect on financial markets is very real. Note the outperformance of the European, Japanese and Chinese markets since those areas adopted aggressive monetary policies, contrasted with the performance of the S&P 500 which has been relatively muted as we near an expected rise in Fed rates.



Fortunately for investors central banks appear as concerned about strong markets as we are, and for the foreseeable future are prepared to provide impetus, in the form of additional liquidity whenever necessary. The U.K. hedge fund manager, Hugh Hendry, perhaps put it best; "In a world where central bankers have your back and where they seem to be underwriting risks and global asset prices, do you require that intense a scrutiny of risk?"

As for some fundamental stuff we are assuming will matter eventually, the U.S. economy has hit another "soft patch" which is being explained away by citing the cold weather and west coast dock strikes. We are watching more recent reports in hopes of seeing a rebound. The 0.9% rise in March retail sales suggests just such an outcome.

China reported 7% growth in the 1st quarter, the slowest rate since 2009, which is fine and dandy as long as the slowdown remains controlled. It is not reassuring to see a headline quote from Premier Li, "downward pressure on economy increasing." Yet as mentioned above, their stock market is on wheels.



The number three economy, Japan, (actually four if you consider the European Union as one economy) continues to struggle despite the massive amount of stimulus provided by the Bank of Japan. The bright people at Cornerstone Macro point out that the household savings rate in Japan is negative for the first time since such things have been recorded. In order to finance the increase in government debt as a result of the stimulus, foreign buyers must be found. Not an easy task when 10 year yields are at 0.33%.

While by no means "out of the woods", the Eurozone economy is showing some signs of improvement. Quantitative easing seems to be having a positive impact, and low interest rates, the weak Euro and low oil are also helping. Retail sales are up, consumer confidence is at a new high and the Purchasing Manager's Index is reaccelerating. Although, I still have trouble understanding Switzerland issuing 10 year bonds with a negative nominal interest rate, and German bonds, amongst others, trading at a negative real rate.

There has been much to make one concerned about financial markets, yet here we are entering year 7 since the S&P 500 bottom of March 2009. Remain alert! As economist Rudi Dornbusch once said: "Things take longer to happen than you think they will, and then happen faster than you thought they could."

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