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Be afraid

"One disadvantage of asset purchases relative to conventional monetary policy is that we have much less experience in judging the economic effects of this policy instrument, which makes it challenging to determine the appropriate quantity and pace of purchases and to communicate this policy response to the public."

- Federal Reserve chairman Ben Bernanke, referring to quantitative easing.

Or to put it another way: we don't know if it will work, and we don't know how to spin it. These are dismal days. Having exhausted conventional monetary policy, the Federal Reserve is busily exercising its two remaining options: clutching at straws, and pushing on strings. The ultimate outcome from QE2 remains to be seen. In the short term, though, stock markets and indeed most other financial assets have reacted in classic Pavlovian fashion: ring the dinner bell announcing fresh liquidity, and they will rally in response. This should give equity investors pause. Assuming some correlation between economic growth and market return, the announcement of general desperation on the part of the central bank does not equate to a favourable fundamental backdrop for investors. Rather, it merely perpetuates a general euphoria sponsored by liquidity provision and nothing else. The advice for equity market investors must remain: enjoy the party, but dance near the door.

Things are bad enough for the US. QE2 is really a slap in the face for a US electorate that has just loudly rejected further fiscal stimulus – but then the Federal Reserve is not a conventional diplomatically elected body so much as a private banking clique driven by discredited economists (other than the Austrian school, is there any other type ?). Perhaps the purchase of a few more hundred billion Treasuries will turn around an economy stuck with softening house prices, rising foreclosures and deleveraging households. But the Federal Reserve is not trying to manipulate a market and economy in a closed system; the US is not an island. The impact beyond its shores is unsettling, notably for foreign investors whose appetite for holding ever depreciating dollars cannot be taken for granted. This point has been acknowledged by the international chorus of disapproval that has greeted confirmation of QE2, for example in the comment by Wolfgang Schäuble, German finance minister, that Americans accusing the Chinese of exchange rate manipulation were being inconsistent while themselves steering the dollar lower through money printing. The financial media, on the other hand, haven't just lost the plot, they haven't even located the bookstore yet: the Fed, not content with seeing the aftermath of previous asset bubbles that their own monetary policy inflated, is determined to inflate more. This cannot and will not end well. Paper assets are the bubble: the rally in gold is real, in every sense. Note the suggestion reported today by Robert Zoellick, World Bank president, that the world should consider returning to a modified gold standard.

Fellow American David Stockman, director of the Office of Management and Budget under Ronald Reagan, was pulling few punches when he spoke to Bloomberg News recently:

"An independent Fed is what we had when I was in the government. Volcker was the head of it…Today the Fed is scared to death that the boys and girls and robots on Wall Street are going to have a hissy fit. And therefore these programs, one after another, are simply designed to somehow pacify the stock market, and hoping to keep the stock indexes going up, and that somehow that will fool the people into thinking they are wealthier and they will spend money. The people aren't buying that. Main Street is not stupid enough to believe that engineered rallies as a result of QE2 stimulus are making them wealthier and so they should go out and buy another Coach bag. This is really crazy stuff that I can't say enough negative about…The Fed is telling a lot of lies to the market… it is telling all the politicians on Capitol Hill you can issue unlimited debt because it doesn't cost anything. We have $9 trillion of marketable debt. Upwards of 70% of that has maturities of 5 years or less down to 90 days. All of those maturities are [in yield terms] 1% down to 10 basis points. So from the point of view of Congress, the cost of carrying the debt is essentially free. When you tell politicians they can issue $100 billion of debt a month for free, how do you expect them to do the right thing, and ask their constituents to sacrifice… **I think the Fed is injecting high grade monetary heroin into the financial system of the world, and one of these days it is going to kill the patient.**"

Moving somewhat closer to home, while it was always going to be impossible to construct a commentary this week without disparaging QE2, it was also going to be impossible without mentioning the state of the credit markets in Europe. The US government bond market will doubtless see its Waterloo in the fullness of time, but in Europe, the watershed moment in government bonds may already be here. Following an EU summit last month, Germany won agreement for a permanent scheme to deal with Europe's weaker sovereign borrowers, which is likely to involve a mechanism for arranging "orderly" defaults. The Germans have finally got tired with writing unlimited cheques to feckless Greeks. On Friday, Greek 10 year bonds fell for the tenth day in a row, and Irish 10 year bonds for the ninth.

May you rise without falling: 10 year Irish government bond yields

Source: Bloomberg LLP

Andy Xie ("To Hell Through QE") puts it rather soberly:

"The world is heading towards high inflation and political instability. It's only a matter of time before there is another global crisis. The first sign would be a collapsing treasury market. The Fed is controlling the yield curve through its QE program. But, it is irrational for other investors to play this game. The only reason to stay in is that the Fed won't let the market fall. But, the underlying value is evaporating with rising money supply and the inflationary consequences. When all investors realize this, they will run for the exits and the Fed won't be able to stop the stampede. If it prints enough money to take over the whole market, the people with freshly minted dollars would surely want to convert their money into other assets..

"The world seems on course for another crisis in 2012. The same people who caused the last crisis are still in charge. They'll get us into another. Iceland is sending its former prime minister to court for causing the banking crisis. A worse fate awaits the people who are causing the next crisis."

In summary, quantitative easing is a fraud, a last-ditch throw of the dice. Because its ultimate outcome is likely to be inflationary, ownership of real assets has validity. But simply hitching your cart to the stock market isn't the answer – unless you can time your exit to perfection, because at some point the market will start to fret about when QE **stops**. Better by far to concentrate on the highest quality assets available in each category. In government debt, that amounts to those countries with the greatest potential to be able to pay you back – **not** those countries that have issued the greatest amount of debt, nations which therefore comprise the largest components of government debt indices. In equity markets, sensibly priced businesses that are suppliers of inherently scarce products and services with unlimited demand (not least, energy and infrastructure) look particularly attractive. Notwithstanding the temporary multiple correlations of 2008, it still makes absolute sense to diversify. And gold, of course, is still a core hold.

On a lighter note, the people who brought you 'Fear the Boom and Bust' (Hayek vs Keynes in rap) have come up with a sequel, via the Economist's Buttonwood Conference. Hat tip, as always, to TD's Jonathan Escott. There are no times so bad, and no over-rated economic thinking so awful, that we cannot at least laugh at them.

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