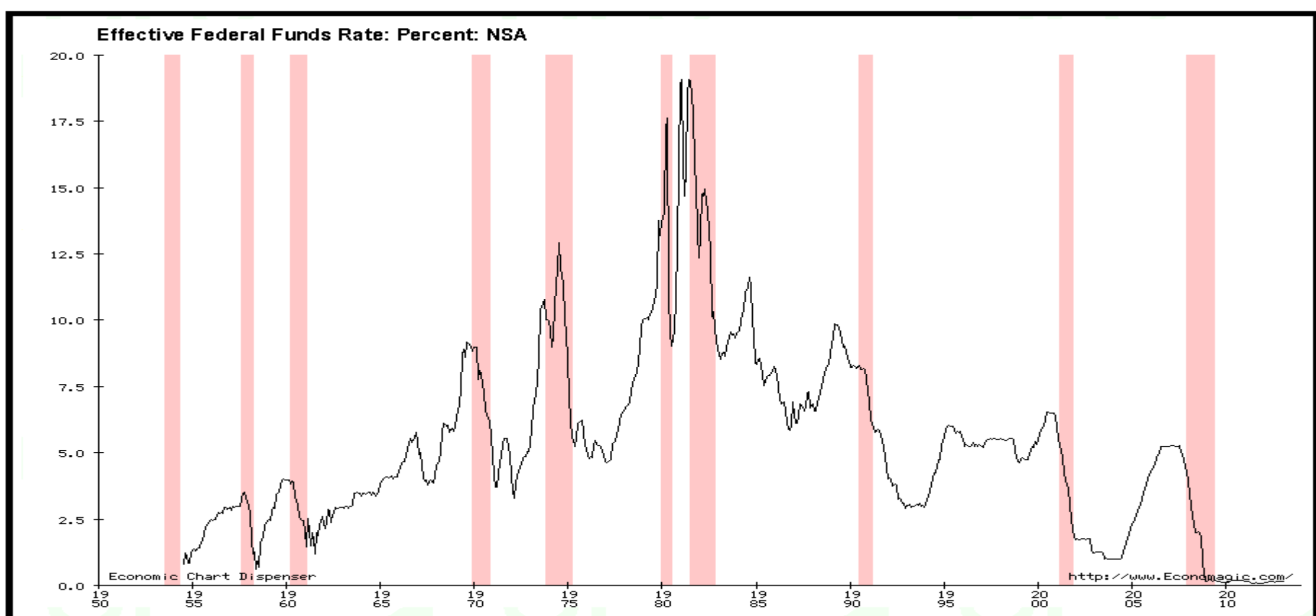
MONETARY POLICY IS KEY

BIG PICTURE – The world's economy is muddling through and the majority of nations in the developed world are struggling. Furthermore, unemployment in the West is staying stubbornly high and sovereign debt levels are soaring! Thus, the macro-economic environment is currently unfavourable and unsurprisingly, the investing public is struggling to come to terms with the ongoing uptrend on Wall Street. After all, with so much bad news out there, how can stocks continue to rally?

The truth is that when it comes to investing, monetary policy trumps economic reality and the risk free rate of return determines the prices of all assets. In fact, history has shown that as long as central banks stay in 'easing mode', the economy continues to expand; thereby underpinning the stock market. On the contrary, after a period of monetary tightening, the economy tends to contract and a recession usually coincides with a big downtrend in the stock market.

In case you are sceptical, Figure 1 confirms that every single economic recession in the US (pink shaded areas on the chart) since 1955 was preceded by a significant increase in the Federal Funds Rate. Put another way, none of the previous economic recessions occurred without a significant increase in the Federal Funds Rate.

Figure 1: Monetary tightening causes recessions

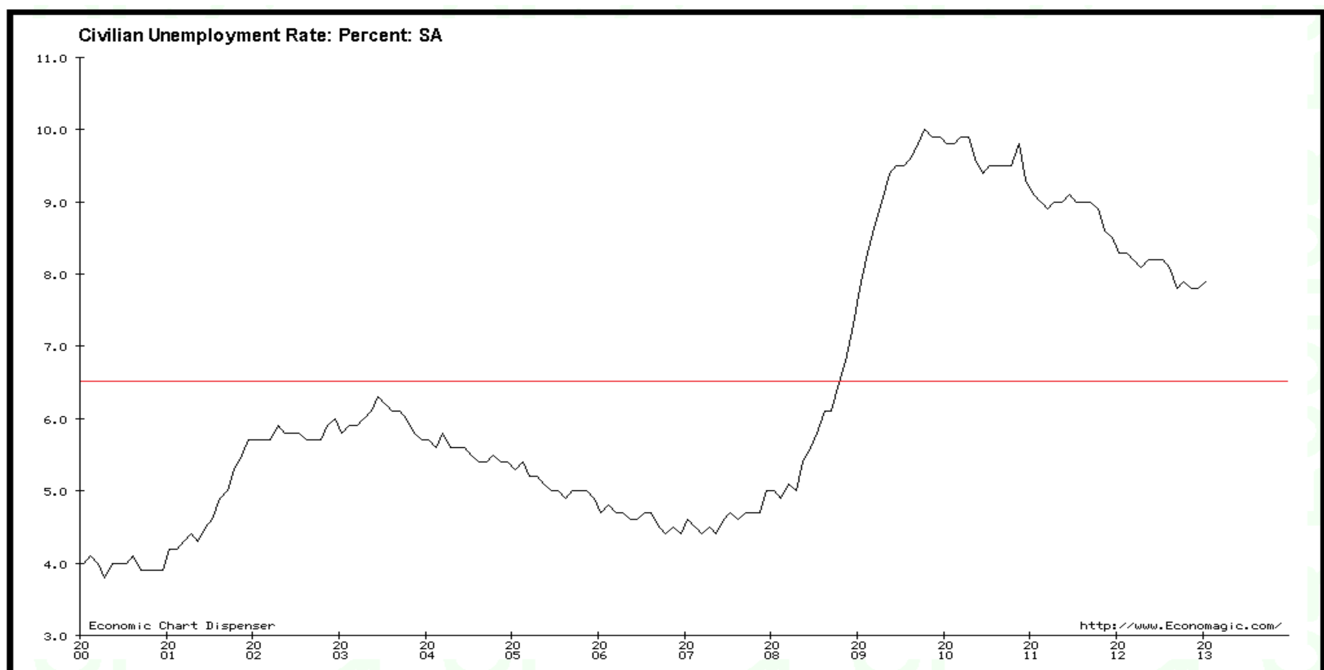


Source: www.economagic.com

Today, the Federal Funds Rate is at a record-low and Mr. Bernanke has made it clear that until the US unemployment rate comes down to 6.5%, the central bank will *not* raise short term interest rates. Furthermore, the Federal Reserve has explicitly stated that it will leave rates unchanged well into the economic recovery.

At this stage, nobody knows when the US unemployment rate will decline to 6.5%, but in a recent speech, Mr. John C. Williams (President and CEO, Federal Reserve Bank of San Francisco) opined that he expects the US unemployment rate to stay above that level until the second half of 2015. Currently, the civilian unemployment rate in the US stands at 7.9% (Figure 2) and if Mr. Williams' assessment is correct, then the Federal Funds Rate will remain unchanged for at least another 2½ years!

Figure 2: US unemployment rate is the key



Source: www.economagic.com

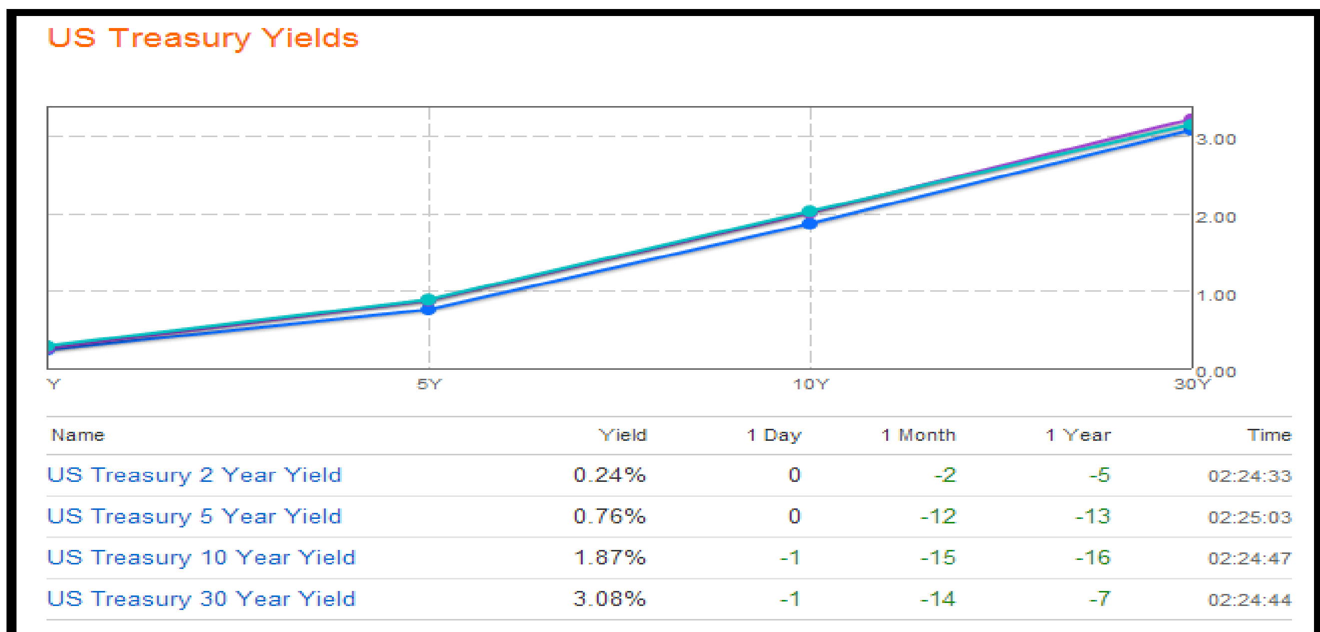
It is interesting to note that during his presentation at the Forecasters Club in New York, Mr. Williams went on to say that the Federal Reserve will keep rates exceptionally low at least as long as, *one*, the unemployment rate remains above 6.5%; *two*, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2% longer-run goal; *and three*, longer-term inflation expectations remain in check.

As things stand today, the unemployment rate is well above the Federal Reserve's target, the CPI is below the 2% level and longer-term inflation expectations are in check. Thus, for the time being, there is absolutely no reason for the Federal Reserve to raise its short-term interest rate. Moreover, given the sub-par economic growth in the US, it is probable that the unemployment rate will stay above the 6.5% level for another 2-3 years.

Bearing in mind the above, it is extremely likely that the Fed Funds Rate will remain unchanged for another 3 years and this scenario will continue to support the ongoing uptrend in America's stock market. Of course, this rally will be punctuated by periodic corrections; nonetheless, as long as the monetary policy remains unchanged, the uptrend should continue.

When it comes to investing, nothing is set in stone. However, it is worth noting that previous economic recessions and bear markets were preceded by the inversion of the yield curve. Fortunately, thanks to central bank intervention, the yield curve in the US is still steep (Figure 3) and this implies that we are nowhere near the next bear market in American stocks.

Figure 3: US Yield Curve is steep



Name	Yield	1 Day	1 Month	1 Year	Time
US Treasury 2 Year Yield	0.24%	0	-2	-5	02:24:33
US Treasury 5 Year Yield	0.76%	0	-12	-13	02:25:03
US Treasury 10 Year Yield	1.87%	-1	-15	-16	02:24:47
US Treasury 30 Year Yield	3.08%	-1	-14	-7	02:24:44

Source:Bloomberg

In our view, given Mr. Bernanke's monetary policy, the US yield curve will *not* invert for at least another 2-3 years and this should bode well for Wall Street.

Look. Wall Street has already gyrated within a wide trading range for 13 years, monetary policy is extremely favourable for stocks, valuations are reasonable and investor sentiment is negative. Thus, based on historical precedence, the stage is now set for a *multi-year* secular uptrend and we continue to believe that the S&P500 Index will probably climb to an all-time high over the following months.

It is noteworthy that already, a number of the sub-indices have surpassed their previous highs and a recovery in the depressed financial stocks will confirm the new secular uptrend in the S&P500 Index.

Remember, Mr. Bernanke's QE-*ternity* program is designed to repair the banks' balance-sheets and this strategy should restore investor confidence in the financials. When investors turn to this sector, we will probably see an explosive rally which will send the S&P500 Index to an all-time high.

As you can see from Figure 4, the S&P500 Index is approaching an area of stiff overhead resistance and psychologically, many nervous investors are now bracing for yet another stock market crash. However, before you batten down the hatches, you may want to note that the previous two downturns in the S&P500 Index were preceded by a series of interest rate hikes by the Federal Reserve, which ended up killing the uptrend.

This time around, the Fed Funds Rate is at 0.25% and Mr. Bernanke has made it clear that short term interest rates will remain unchanged for an extended period. Thus, the current monetary backdrop is not hostile and in our view, a prolonged bear market is highly unlikely.

Figure 4: S&P500 Index *(monthly chart)*

Source: www.stockcharts.com

Although we do not possess a crystal ball, we believe that under the best case scenario, the S&P500 Index will blast straight through this overhead resistance and if things get a bit wobbly, we may get a brief consolidation before liftoff.

In any event, unless there is a sovereign default in Europe, we expect the S&P500 Index to trade in uncharted territory in the not too distant future. Furthermore, given the nascent recovery in America's housing market, we believe that Wall Street will be one of the star performers over the following decade. Accordingly, in our equity portfolio, we have gained a large exposure to American stocks.

In terms of specific sectors, we are of the view that the beaten down financials and housing related stocks will provide good opportunities. Furthermore, we suspect that the consumer related companies and healthcare businesses will also prosper over the following years.

In summary, as long as the Federal Reserve remains committed to its monetary stimulus, Wall Street will probably remain in an uptrend and eventually, interest rate hikes will usher in the next bear market.

COMMODITIES – The global economy is passing through a low growth environment, aggregate demand is currently weak and there is no shortage of natural resources. Consequently, the prices of commodities are deflating and the ongoing downtrend is now almost 2 years old.

It is notable that the Reuters-CRB (CCI) Index peaked in April 2011 and although the anticipation of QE-*ternity* triggered a brief rally between June and September last year, prices promptly reversed lower after Mr. Bernanke's official announcement. It goes without saying, this was a classic case of the market 'buying the rumour and selling the news'!

At present, the prices of commodities are in a persistent downtrend and the CCI Index has now declined to a multi-month low. As you can see from Figure 5 since September 2012, the CCI Index has formed a series of lower highs and the recent leg down has sliced through the previous low recorded in January. In other words, for several months now, the CCI Index has been carving out lower highs and lower lows and this price action confirms that we are in a downtrend. Furthermore, Figure 5 shows that the CCI Index is now trading below the key moving averages and this implies that momentum is rolling over.

Figure 5: Commodities are deflating

Source: www.stockcharts.com

Unfortunately, for the commodities bulls, the world's reserve currency is appreciating and since natural resources are priced in US Dollars, their prices are falling. Remember, commodities are inversely correlated to the direction of the greenback and if the US Dollar has now embarked on a major uptrend, this will keep a lid on prices.

For sure, within the commodities complex, a few individual items may buck the overall downtrend from time to time. However, we believe that such rallies will prove to be unsustainable and 'buy & hold' investors will be disappointed.

Turning to specific commodities, it appears as though both copper and crude oil have rolled over and their prices are likely to depreciate over the following weeks. In our view, this weakness in these key industrial commodities suggests that the world's economy is slowing down and there is a shortage of aggregate demand.

Elsewhere, within the agricultural space, prices are falling rapidly. For instance, over the past several months, the prices of coffee, sugar and wheat have declined by 50% or more and for now, it appears as though there is no shortage of food supplies.

In summary, despite what the experts may tell you, commodities are currently in a persistent downtrend and unless prices start firming, this is *not* the time to invest in this sector.

PRECIOUS METALS – Central banks are debasing their currencies, debt levels are exploding and deficit spending has become the norm. Yet, precious metals are struggling to embark on a major uptrend and if you own gold or silver, this should be a reason for concern. After all, the macro-economic environment is now ideal for precious metals, but it seems as though the sellers have been in control of this market.

At present, nobody really knows why the prices of gold and silver are struggling. However, it is conceivable that after a lengthy bull-market, global 'stimulus' has already been discounted by the market. Furthermore, it is also possible that the market is now looking beyond the economic woes and focusing its attention on America's nascent housing recovery.

In any event, the reasons are largely irrelevant; what matters is that precious metals are struggling and if you have any positions in gold, you really do not want its price to fall below last year's low. Figure 6 (weekly chart) shows that gold is currently trading just above a critical support level and a decisive close beneath the US$1,520-1,530 per ounce level will confirm the end of the secular uptrend.

Figure 6: Gold is at a critical juncture

Source: www.stockcharts.com

For our part, we currently have no exposure to the yellow metal but if you do own some gold, you may want to monitor the US$1,520-1,530 per ounce area like a hawk. Should the price of gold slice through that level, you may want to promptly liquidate your positions.

At this stage, it is difficult to tell whether that area of support will hold. However, the recent abysmal performance of the AMEX Gold Bugs Index is *extremely* discouraging and since the miners tend to lead the physical metals, caution is warranted.

If you review Figure 7, you will note that the AMEX Gold Bugs Index came under heavy distribution in 2011 and after forming a classic rolling top, it broke down last year. Thereafter, we got a brief QE-*ternity* inspired rally which peaked shortly after Mr. Bernanke's announcement. Since then, the AMEX Gold Bugs Index has been a disaster show and it has now fallen below last summer's low. Whether you like it or not, this price chart looks awful to us and we never like to catch falling knives!

Figure 7: AMEX – Gold Bugs Index *(weekly chart)*

Source: www.stockcharts.com

In our view, the recent slide in the AMEX Gold Bugs Index is ominous and the mining stocks are now trading at levels not seen since 2009! More importantly, the miners are underperforming at a time when the broad stock market is buoyant and this is not a good sign.

You will recall that for 2-3 years now, our advice has been to avoid the miners and currently, we have no exposure to this sector. If you still have not sold your positions, we suggest that you consider liquidating your positions promptly and getting out of harm's way. Remember, nobody rings a bell at major tops and 'buy & hope' is not an effective strategy.

For the record, we believe that the AMEX Gold Bugs Index is forecasting trouble for the precious metals sector and this is not the time to be invested in bullion or the mining stocks.

CURRENCIES – The world's reserve currency is strengthening and for now, the US Dollar is being perceived as the least ugly contestant!

After all, the US is still the world's largest economy and due to its ability to create its own currency, it may *never* default on its debt. Furthermore, the recent improvement in America's housing market is also encouraging and perhaps this is why investors are flocking towards the greenback?

On a more sobering note, it may well be that the US Dollar is appreciating because there are no viable alternatives! If you review the major currencies available to investors today, you will note that the British Pound is really struggling, the Euro has its own problems, the Japanese Yen is being devalued and the Swiss Franc is no longer a free floating monetary unit! Furthermore, thanks to the recent slump in commodities, the Australian and Canadian Dollars are also showing signs of weakness. Thus, amongst the more liquid currencies, investors do not really have much of a choice and this sad state of affairs may explain the ongoing rally in the US Dollar.

From a technical perspective, it is interesting to observe that the US Dollar Index has now climbed above the 200-day moving average and it has also surpassed its November high (Figure 8). Furthermore, it is now trading above all the key moving averages, which suggests that the momentum currently favours the greenback. In our view, as long as the US Dollar Index stays above the 81-81.5 area, the path of least resistance will remain up and other currencies will continue to drift lower.

Figure 8: World's reserve currency is appreciating!

Source: www.stockcharts.com

Already, with the exception of the Euro, all of the above-mentioned major currencies have slipped below the 200-day moving average and further weakness is likely. Thus, as long as the uptrend in the US Dollar prevails, cash should be held in the world's reserve currency.

BONDS – Let's face it; over-indebtedness is the root cause of the world's economic woes and as long as debt pardoning does not occur; business activity will not pick up in a meaningful manner. Furthermore, government deficit spending will only compound the problems and further diminish the prospects of a robust economic recovery.

In our opinion, as long as the debts keep building up via deficit spending, economic growth will remain sluggish. Moreover, since long-term bond yields are positively correlated to economic activity, it is probable that (apart from periodic rebounds) they will continue to drift lower for the foreseeable future.

As you can see from Figure 9, the 30-Year US Treasury Yield topped out in April 2010 and today, it stands at 3.06%. Furthermore, it is interesting to note that over the past 3 years, the 30-Year US Treasury Yield peaked during the spring months (blue arrows on the chart) and it appears as though something similar may play out this year.

Figure 9: 30-Year US Treasury Yield – rolling over?

Source: www.stockcharts.com

For several months now, we have been of the opinion that long-term interest rates in the US cannot go up and stay up. Today, with long-term US Treasury yields around 3%, our view remains the same.

Although the Federal Reserve's QE initiatives have managed to *temporarily* boost inflation expectations and long-term interest-rates; the underlying economic fundamentals have ensured they have not been able to remain elevated. Thus, unless the aggregate demand picks up promptly and the economy powers ahead (unlikely due to over-indebtedness), it is probable that long-term interest rates in the US and in other developed nations will continue to drift lower for several years. Thus, if investors have exposure to risky assets (stocks, commodities or high yield bonds), they may want to hedge their portfolio by allocating some capital to US Treasuries which will perform well in a deflationary environment.

In addition to US Treasury securities, we are of the view that high-yield corporate bonds will continue to attract investors' capital. After all, short-term interest rates are at historic lows and under this environment, income seeking investors will keep purchasing high-yield debt.

Undoubtedly, high yield bonds have already enjoyed a fabulous run and yield spreads are very compressed. However, as long as the Federal Reserve pursues its expansionary monetary policy, the party will probably continue and the bubble will get even bigger.

Make no mistake, rising interest rates are a real threat to the high-yield bond market and for sure, one day the party will end. In the meantime however, investors need income and one way to mitigate the interest-rate risk is to purchase individual medium-duration corporate bonds and hold them until maturity.

From our perspective, we have put together a fixed income portfolio of US Dollar denominated corporate bonds and despite the recent run up, it is still providing a yield of approximately 6% per annum.

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