

A voice of reason

Friday, 20 August, 2010

In a powerful speech entitled "*Hard Choices*", Kansas City Fed President Thomas Hoenig last week articulated the case for ending the US central bank's "*extended period*" commitment and starting to normalise monetary conditions to avoid repeating mistakes made after the last two recessions. Speaking in the plains city of Lincoln, Nebraska (population 250,000) on August 13, he arguably delivered the most important policy speech of the year, a damning insider's critique of the past failures of monetary policy and most economists' commentary over the last 15 years. Perhaps only someone who witnessed the savings and loan scandals of the 1980s as a senior banking supervisor, and has served on the Federal Open Market Committee (FOMC) since 1991, including during previous deflation scares, has the perspective and lack of further ambition to speak truth unto power.

Hoenig outlined four compelling reasons to begin gradually lifting interest rates: (1) "*Trend data show modest recovery*," according to Hoenig. "*Recovery is proceeding as many economists earlier this year outlined that it would*." While month to month data are mixed, there is a consistent positive trend, and the economy is on track to expand by around 3.0% for the remainder of the year. "*While we are not where we want to be, the economy is recovering and, barring specific shocks and bad policy, it should grow over the next several quarters*." Hoenig repeatedly noted the recovery is proceeding faster than upturns after either the previous recessions, in part because the much greater depth of the latest downturn leaves more scope for a rebound. But there is no sign the expansion lacks momentum. (2) "*Corrections take time*". Trying to accelerate them by leaving interest rates too low for too long risks repeating errors made after recessions in 1990-91 and 2001. "*If we again leave rates too low, too long out of our uneasiness over the strength of the recovery and our intense desire to avoid recession at all costs, we are risking a repeat of past errors and the consequences they bring*." Hoenig catalogued the imbalances which built up during the 1990s and the first seven years of the current century, arguing they cannot be corrected quickly. (3) "*It is not time for tight policy*." Hoenig wants policy to remain accommodative but move gradually towards balance as the recovery proceeds. He advocates dropping the "*extended period*" commitment and replacing it with a conditional commitment to increase rates to 1.00% by a given date, subject to satisfactory economic performance. After a pause, rates would move up towards 2.00%. Thereafter, rates would be set as normal, conditional on economic performance. Hoenig warned bluntly in his speech "*if in an attempt to add further fuel to the recovery, a zero interest rate is continued, it is as likely to be a negative as a positive in that it brings its own unintended consequences and uncertainty*. He went on to say that "*a zero policy rate during a crisis is understandable, but a zero rate after a year of recovery gives legitimacy to questions about the sustainability of the recovery and adds to uncertainty*". (4) "*Market participants should not direct policy*." Hoenig warned his colleagues not to heed self-interested calls for cheap money emanating from Wall Street and regional banks. "*Of course the market wants zero interest rates to continue indefinitely. They are earning a guaranteed return on free money from the Fed by lending it back to the government through securities purchases*."

Hoenig noted that the drumbeat of pessimistic commentary in Summer 2010 is like the angst-ridden news reports from the Spring and Summer of 2003, which prompted the Fed to make one final, mistaken cut in interest rates to 1.00% in June of that year. Hoenig was serving on the FOMC then and is clear it was a mistake. "*With the low rates very low for a considerable period of time, credit began to expand significantly and set the stage for one of the worst economic crises since the Great Depression. In my view, it was a very expensive insurance premium. I fully acknowledge that I was on the FOMC at that time. That's why I believe that zero rates during a period of modest growth are a dangerous gamble*." While noting the Great Depression holds lessons for policymakers (such as not prematurely doubling reserve requirements as was done in 1937-38) he urged them not to ignore more recent lessons from policy mistakes made during the re-inflating periods of the 1990s/ early 2000s. And the worry is Hoenig will be proved right.

2/3 Exchange Place, IFSC
Dublin 1, Ireland
DX no: 64
Tel: +353 (0)1 611 9200
Fax: +353 (0)1 829 1877

86 South Mall
Cork, Ireland
DX no: 2008
Tel: +353 (0)21 490 6500
Fax: +353 (0)21 427 6036

100 O'Connell Street
Limerick, Ireland
DX no: 3046
Tel: +353 (0)61 414 065
Fax: +353 (0)61 419 750

info@bloxham.ie
www.bloxham.ie

International Bonds/Equities:

Forget about politics, the biggest divide in the US at the moment is between stock and bond investors, who aren't so much arguing as speaking entirely different languages. Equities, while about flat for the year to date, are priced moderately cheaply by historical standards, implying that investors think they have a reasonable, if not spectacular, outlook for the next couple of years. Earnings are strong, and forward-looking estimates of earnings, while coming somewhat off the boil, are still rosy and cash balances are high. Bonds, in contrast, are telling you that the United States will be dicing with deflation and recession over the same period, painting a landscape in which the right thing is to hang on to your capital. ***The bottom line is that with the yield on a 10-year government bond at 2.56% and the earnings yield on the S&P 500, measured on a standard accounting basis, at 6.23%, somebody, to put it mildly, is going to end up disappointed.***

There is simply no way that earnings can stay that high relative to stock prices while bond yields stay that low. If the earnings can be sustained, stock prices will rise. If that scenario plays out, here's betting the whole deflation and recession thing will have given way to either moderate growth and even possibly inflation. If so, you will not want to be one of the people who two weeks ago bought a three-year bond from IBM that yields, wait for it, 1.00% or the kind of coupon that makes you think Franklin D. Roosevelt must be speaking on the wireless again. Nor, if the stock market proves more right than wrong, will you want to be one of the people holding AAA non-financial debt, which now yields 4.72%, the lowest in almost 45 years. So, are bonds in a bubble and should investors reverse course and re-allocate to equities? Probably not. ***The bond market is not in a panic and the kinds of returns being generated are not the kind one normally associates with speculative frenzy.*** In fact the one real scene of frenzy in the bond market is in high-yield, or junk bonds, where issuance is positively booming. Interestingly, though as borrowers are jumping over each other to sell high-yield bonds, they are doing it into a market that is requiring them to pay a heck of a lot in interest for the privilege. ***Despite the fact that high-yield defaults are less than half their historic average, the yield spread on junk bonds compared to US Treasuries is about 60bps wider than the average over the past 12 years, with the discrepancy signalling about a one in four chance of a recession.***

A look at the market for Treasury Inflation-Protected Securities (TIPS), bonds which pay more or less based on actual consumer price inflation, underscores the extreme disconnect between stocks and bonds. The real yield on 10-year TIPS is only 1.00%, while 5-year TIPS yield essentially zero and 3-year TIPS have a negative yield. If those yields come anywhere near to reality, it will be a very fine company indeed which can produce competitive returns for its stockholders. ***TIPS are implying, at best, that there is absolutely nothing to fear from inflation and at worst, that the US is heading into a period of deflation and a sustained period of very low growth.*** TIPS contain two features that are extremely valuable under current circumstances. Although real yields on TIPS are extremely low, investors always get back 100 cents on the dollar, even if inflation turns negative, and those 100 cents are growing in purchasing power, making it a hedge against deflation. At the same time, TIPS, by their nature, offer protection against inflation, which many believe could get out of control if the Fed is forced to take more desperate measures. Analysing the meaning of the bond market is a heck of a lot more difficult now, however, for the simple reason that quantitative easing is distorting its message. As the Federal Reserve buys government bonds they artificially lower what we used to think of as the risk-free rate. This is intended to induce us to take on more risk in order to revive the economy, but it might also make government bonds give artificially gloomy signals while other risk assets are made artificially cheerful. ***In the end, the stock and bond markets may well split the difference, but as always, it pays to apply a heavy discount to almost everything you are told about equities.***

Currencies/Commodities/Interest Rates

Bank of England policymakers considered the case for both easing and tightening monetary policy this month, before voting eight to one to keep interest rates at a record low of 0.50%, minutes of the August MPC meeting showed this week. Monetary Policy Committee member Andrew Sentance called for a 25bps rate hike for the third month running, but the majority of the MPC thought it would be best to keep interest rates on hold and maintain the central bank's £200bn asset purchase scheme because of significant risks on both sides of the inflation outlook. **The underlying tone of this month's discussion suggests that the MPC is firmly in neutral mode, though the members stand ready to respond in either direction as the balance of risks evolves.** The Bank cut interest rates to a record low in March last year and embarked on an unprecedented quantitative easing programme to pull Britain out of its deepest recession since World War Two. While the UK economy has started to grow again, most analysts anticipate a slow and difficult recovery, weighed down by swingeing budget cuts by the new coalition government. **There had been some speculation prior to the release of these latest minutes that the Bank could have been split three ways, meaning one or more members voting for further quantitative easing to support the recovery, but that wasn't the case.**

The MPC considered arguments in favour of further monetary easing because credit conditions looked as if they would remain tighter than the central bank had anticipated in May. The Conservative/LibDem government's Budget on June 22 had also cut the growth outlook and a weakening in business and consumer confidence might also weigh on activity. However, Sentance argued that the recovery was already gathering momentum and there was a risk that inflation expectations could become de-anchored. Inflation has been surprisingly strong in 2010, posting a rate of 3.1% in July, which forced Bank of England Governor Mervyn King to write a public letter of explanation to the government for the third time this year. In his letter, he repeated that he expected inflation to fall over the next two years and blamed one-off factors such as a rise in VAT sales tax and the effect of sterling's previous weakness. But, the minutes showed that policymakers are worried that a recent spike in wheat prices could feed through to higher consumer prices this year. "Increases in the prices of some agricultural commodities in the days leading up to the meeting suggested that the increased volatility of CPI inflation seen in recent years might continue," the minutes said. **We still think that UK inflation risks are tilted to the upside, and continue to believe that the Bank of England will be raising official interest rates sooner than the market expects.**

Exchange Rates 2010/2011

	Current	End Sept (f)	End Dec (f)	End Mar (f)	End June (f)
€/GBP	0.8216	0.8150	0.8000	0.7800	0.7500
€/\$	1.28	1.24	1.18	1.16	1.15
€/Yen	109	106	103	100	100
\$/Yen	85	85	87	86	87
GBP/\$	1.55	1.52	1.48	1.49	1.53

Official Interest Rates 2010/2011

	Current	End Sept (f)	End Dec (f)	End Mar (f)	End June (f)
US	0.25	0.25	0.25	0.25	0.50
Eurozone	1.00	1.00	1.00	1.00	1.00
Japan	0.10	0.10	0.10	0.10	0.10
UK	0.50	0.50	0.50	0.75	1.00
Canada	0.75	1.00	1.00	1.25	1.50
Sweden	0.50	0.75	1.00	1.25	1.50
Norway	2.00	2.00	2.25	2.50	2.75
Switzerland	0.25	0.50	0.75	1.00	1.25
Australia	4.50	4.50	4.75	5.00	5.00
New Zealand	3.00	3.25	3.50	3.75	4.00
China	5.31	5.31	5.58	5.85	6.12

2010/2011 Native Global Bond Yield Forecasts %

	Current	End Sept (f)	End Dec (f)	End Mar (f)	End June (f)
US					
2 Year Treasury	0.48	0.65	1.05	1.55	2.05
5 Year Treasury	1.37	1.55	1.85	2.25	2.65
10 Year Treasury	2.56	2.70	2.95	3.25	3.55
30 Year Treasury	3.62	3.75	3.95	4.20	4.50
Germany					
2 Year Bund	0.64	0.80	1.10	1.45	1.80
5 Year Bund	1.30	1.45	1.70	2.00	2.30
10 Year Bund	2.30	2.40	2.60	2.85	3.10
30 Year Bund	2.96	3.05	3.25	3.50	3.75
UK					
2 Year Gilt	0.64	0.85	1.20	1.60	2.00
5 Year Gilt	1.71	1.90	2.20	2.55	2.90
10 Year Gilt	2.99	3.15	3.40	3.70	4.00
30 Year Gilt	4.03	4.20	4.45	4.75	5.05

continued overleaf

Key International Economic Indicators/ Events of the Week

Germany: Ifo Index (August) (Wednesday 25th, 9.00 BST)

2000=100	Headline Index	Current Assessment	Business Expectations
2009 August	90.7	86.3	95.3
2010 June	101.8	101.1	102.5
2010 July	106.2	106.8	105.5
2010 August (f)	107.0	107.6	106.4

July's rise in the German Ifo index suggests that the economy is performing very well despite signs of a slowdown in the US and elsewhere. The increase in the headline business climate indicator from 101.8 in June to 106.2 was much better than the consensus forecast of a fall to 101.5 and left it at a three-year high. The rise in the Ifo mirrored the increase in the manufacturing PMI for last month, suggesting that annual GDP growth could accelerate towards 4.0% in the coming months. The recovery has so far been export-driven and the manufacturing component of the Ifo rose sharply again in July. On the face of it, last month's sharp rise in the retail index was another encouraging sign, and together with recent falls in unemployment, hint that the improvement might spread to the consumer sector. However, with the German government increasingly determined to tighten fiscal policy from next year on, it is hard to see a significant consumer revival. Still, there are really some positive signs here for Europe's largest economy, with every chance now that it will expand by 2.0% or higher in real terms this year. But, unless a German domestic demand revival starts soon, growth looks set to slow in 2011 and the positive effect on the rest of Euroland will be limited.

We expect the headline Ifo index to pick up to 107.0 in August, pushing Bund yields higher as a result.

Sweden: NMA Public Finances Outlook (Friday 27th, 9.00 BST)

Sweden's National Management Authority (NMA) is due to publish its latest outlook for the country's public finances. With Sweden faring better than most on the economic front, the likelihood is that the NMA will be more upbeat than previous as regards the underlying budgetary situation. Back in June, Sweden's National Debt Office forecast a 14bn krona deficit this year and 8bn krona in 2011, as against its March projections for 53bn krona and 37bn shortfalls respectively. The latest NMA outlook is also likely to reflect an improving economic/underlying budgetary position.

This latest public finances outlook should be positive for SGBs, particularly long-dated issues, flattening the yield curve as a result.

US: GDP (Qtr 2 Provisional) (Friday 27th, 13.30 BST)

	Annualised Growth
2009 Qtr 2	-0.7
2009 Qtr 4	5.0
2010 Qtr 1	3.7
2010 Qtr 2 (f)	1.4

The advanced second-quarter US GDP figures were not half as bad as they appeared at first glance. Although GDP growth slowed, from 3.7% annualised in the first quarter to 2.4% in the April-June period, that slowdown was more than explained by a much smaller boost from inventory rebuilding and an enormous spike in imports. However, the June trade figures released after the first estimate of GDP suggest that the initial estimate of a drag of almost three percentage points from net external trade will be revised higher in these latest GDP figures. June's international trade figures indicate that the United States cannot rely on a boost from overseas demand to offset the current weakness of the domestic economy. In fact, the rebounding trade deficit is exacerbating the downturn.

The June trade deficit jumped to a 20-month high of \$49.9bn from \$42.0bn in May, and the increased deficit is likely to push annualised GDP growth in the second quarter down to a revised 1.4%, boosting the allure of Treasuries further, and sending bond yields even lower in our view.

Main Debt Auctions/Announcements in the Coming Week:

Monday 23rd	French Treasury sells BTFs.
	Germany sells €4bn of 12-month Bubills.
	Belgium sells OLOs.
	Italian Treasury details amount of CTZs to be auctioned on August 26, BTPei (Eurozone index-linked fixed rate bonds) to be auctioned on August 27, and BTPs and CCTs to be auctioned on August 30.
	Slovakia sells July 2011 T-bills.
	Poland sells up to 1bn zlotys of 52-week T-bills.
	Lithuania sells 273-day T-bills.
	Romania sells 800m lei of 182-day T-bills.
	US Treasury sells \$30bn of 3-month and \$30bn of 6-month T-bills.
	US Treasury sells \$7bn of 30-year TIPS.
Tuesday 24th	Japan's Ministry of Finance sells 20-year JGBs.
	Spanish Treasury sells 3-month and 6-month T-bills.
	Switzerland sells 6-month T-bills.
	Hungary sells 2-week and 3-month T-bills.
	Malta sells 91-day T-bills.
	Federal Reserve purchases notes/bonds.
	US Treasury sells 4-week T-bills and \$25bn of 52-week T-bills.
	US Treasury sells \$37bn of 2-year notes.
Wednesday 25th	Japan's Ministry of Finance sells 3-month T-bills.
	Italian Treasury details amount of BTPs and CCTs to be auctioned on August 30.
	Sweden's Debt Office sells 10bn krona of 82-day T-bills.
	Hungary buys back bonds.
	Poland holds exchange-rate offer.
	Russia sells up to 15bn roubles of OFZ bonds; series #26203
	Canada sells 30-year real return bonds.
US Treasury sells \$36bn of 5-year notes.	
Thursday 26th	Italian Treasury auctions BOTs and CTZs.
	Hungary sells government bonds.
	Czech Republic sells 8bn crowns of 364-day bills.
	Federal Reserve purchases notes/bonds.
US Treasury sells \$29bn of 7-year notes.	
Friday 27th	Italian Treasury auctions BTPei (Eurozone index-linked fixed rate bonds).
	UK sells T-bills.

Written by Alan McQuaid.
Direct Tel: +353 (0)1 611 9226
E-Mail: mcquaida@bloxham.ie

This publication is solely for information purposes and cannot be construed as a representation by Bloxhams. The views in this report are expressions of opinion and are given in good faith, but are not guaranteed. These are subject to change without notice.

Published by Bloxhams © 2010.

Bloxhams is a Member of the Irish Stock Exchange and the London Stock Exchange.

Regulated by The Financial Regulator.

20/8/10