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# MARKET OBSERVER

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The recovery in the financial markets from the depths of the credit crisis is impressive. What is truly impressive is the recovery in investor risk appetite. This is amazing, given the terrorized and catatonic state of the same investors just a few short months ago.

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The rebound in the financial markets is a positive for economic recovery but it does have a dark side. The monetary stimulus and asset purchase programs of world central banks are responsible for the recovery in the world financial markets. Then again, it was their overstimulation of the credit markets that created the credit bubble in the first place.

## Massive Dollar Arbitrage Speculation

The world central banks are now in the bizarre situation of doing exactly the same thing that caused the recent credit bubble and collapse, only more of it. They are locked into their policies by their collective fear that they will make the 1930s error of removing the stimulus too soon. As we have said previously, this makes it very unlikely that they will remove their stimulus too soon and virtually assures removing it too late.

During the build up for the recent APEC conference, a Chinese official commented that the ultra low U.S. interest rate policy was encouraging levered speculation:

> *"'The continuous depreciation in the dollar, and the U.S. government's indication that, in order to resume growth and maintain public confidence, it basically won't raise interest rates for the coming 12 to 18 months, has led to massive dollar arbitrage speculation,' Liu Mingkang, chairman of the China Banking Regulatory Commission, said in Beijing yesterday."* Bloomberg.com

## "Please Borrow Money"

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This is veritably the pot calling the kettle black. China knows of what it speaks since it has inflated its own property and financial markets by its diktat to its State controlled banks to lend more money. Bloomberg.com recently interviewed Zhang Xin, CEO of Soho China Ltd., a real estate developer. Mr. Xin summarized succinctly the problem that the Chinese and all global central banks now face:

> *"When the system is filled with cash, it will find its way to property, whether it's commercial or residential; it also finds its way to stock markets…We have banks coming to us and saying 'please borrow money."* Bloomberg.com

It's not like the world's central bankers don't understand what they are doing. They know only too well from their previous experiences that Mr. Xi is right. Their problem is the same one that Bernie Madoff encountered prior to his scam coming to light. Mr. Madoff's clients wanted the unattainable; high and steady returns with low risk and he gave them what they wanted. Madoff could not admit to the ugly reality that he couldn't deliver on his promised investment returns. Once Madoff made his first fictional client statement, he was locked into his own professional purgatory. To the outside observer, he was an omnipotent legendary investor beyond reproach. On the inside, Madoff knew the jig would eventually be up.

## Central Banking Madoffs

Central bankers are today in a similar situation to that of Madoff before his fall from grace. They have made an implicit promise to the voting public and their po-

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litical masters that they will orchestrate monetary policy such that there will be endless economic growth and no financial pain. The benighted Alan Greenspan attempted this through his serial rescues of the financial markets and the magic of easy credit. The result was the recent credit crunch. The omnipotent reputation of Alan Greenspan as "The Maestro" who orchestrated unparalleled economic growth and prosperity has now turned into something more akin to Forrest Gump. He was in the right place at the right time.

The current crop of central bankers, led by Ben Bernanke, has managed to rescue the financial system from its credit implosion but they really haven't fixed the underlying problem. The current monetary system of penalizing savers and rewarding borrowers has only become more dependent on low interest rates for its success. The liquidity has floated financial asset prices upwards, based on the ultra low interest rate regime, but it has not dealt with the problem of poor capital allocation.

### The Federal Reserve Septic System

The closest analogy we can devise is that of a household septic system. Those of us with country residences know the basic principal. Household waste flows into the septic tank and is eaten by anaerobic bacteria, breaking it down into a clear effluent which drains into the drainage tile bed. Picture the Federal Reserve Septic System. The Fed sees the terrible loans of U.S. banks. It pumps liquidity into the banking system which causes the prices of these assets to appreciate, but it does not deal with the underlying credit problems. It does not digest the bad loans.

The Fed faces the same issues as a household septic tank. Excess water put through a septic system causes waste to float higher without processing it and swamps the system. This eventually causes the septic tank to overflow in a stinking mess on the pristine green lawn of the homeowner. The Fed has run into the same problem. The liquidity it is printing is keeping financial institutions solvent but does nothing to process their bad loans. Since the U.S. residential property market is not recovering any time soon and the overall economy is tepid at best, the money the Fed pumps into banks flows out into speculation in financial assets of all types, creating an even bigger credit mess. Indeed, several U.S. banks have reported loan growth that is not supporting real economic activity but rather seems to be increased borrowing against speculative assets.

Another more serious problem with a septic system involves waste accumulating in the drainage tile bed. This clogs the drain tile and does not allow proper drainage of the processed liquid. The Fed faces this problem as well. The write down of loans and securities to their actual value would lower bank capital ratios and impair their ability to make further loans to support the strong economic recovery that the Fed and its political master so desire.

### The Bernanke Septic Sucking Service

Governments and central banks have happened on the same solution to both problems as harried homeowners. The homeowner hires, as they called it on Red Green, a "Septic Sucking Service" that comes and vacuums everything out of the septic tank and allows a fresh start. Governments and central banks have bought, lent against and/or insured a wide variety of assets to get the risk off bank balance sheets in the hopes the banks will lend again. The problem is that the liquidity this provides to the banks is now being lent against speculative assets, risking another credit bubble and speculative blow-off once again.

As the Chinese have pointed out about the ultra low U.S. interest rate policy, this tsunami of cash washing into the financial markets has moved up financial asset values around the world. Since the U.S. dollar is the global reserve currency, the ultra easy Fed monetary means there are lots of dollars to lend at very low interest rates. The problem is that, despite recent improvements, the real economy is lag-

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ging the rebound in the financial markets. Although we are constructive on the economic rebound, given the huge support from ultra low interest rate policy, we believe that the U.S. consumer is retrenching and it will take some time for "green shoots" to turn into a spending surge. This is particularly true in the United States since the housing market will be in the doldrums for some time.

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## A Tale of Two Housing Markets

The housing markets around the world are diverging based on the heights reached before the credit crisis. Residential house prices are setting back the most in the U.S., U.K., Ireland, Spain and Portugal where the strength of the bust reflects the strength of the prior boom. In other countries with less distressed residential markets, the liquidity shock from the central banks seems to be going into the housing market. This seems to be the case in China and Hong Kong where the peg to the U.S. dollar has forced ultra easy monetary policy. In Australia and Canada, which missed the worst of the credit crisis, housing prices have rebounded from their setback and are now setting new highs due to very low mortgage rates. In Canada, bidding wars on residential housing are commonplace and both mortgage size and amortization are increasing.

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## Accentuate the Negatives!

The monetary policy makers don't really have much room for maneuver. The only way the modern credit and banking system seems to function correctly is with ultra low interest rates. Now that it is apparent that economic recovery is underway, the monetary authorities are taking great pains to emphasize their commitment to those ultra low interest rates. At an Economic Club of New York luncheon, Chairman Bernanke of the Fed began the new Fed tack of emphasizing slow growth and higher levels of unemployment. Previously, the Fed had been steadfast in its promotion of an economic rebound to build confidence. Now, under criticism for its easy money ways, the Fed has been accentuating the negatives. To quote Chairman Ben:

> *"'Jobs are likely to remain scarce for some time, keeping households cautious about spending,' he said. While payrolls will increase as the economy recovers, unemployment 'likely will decline only slowly if economic growth remains moderate, as I expect.'"* Bloomberg.com

The Fed's public relations campaign also extends to defending against foreign and domestic critics of its sponsoring of leveraged speculation:

> *"'It is inherently extraordinarily difficult to know whether an asset's price is in line with its fundamental value,' Bernanke said. 'It's not obvious to me in any case that there's any large misalignments currently in the U.S. financial system.'"* Bloomberg.com

*What's good for America is good for the world in the eyes of U.S. policy makers.*

This sounds suspiciously like Alan Greenspan in his denial phase. Why prick a bubble when you don't have to? Since the most bubbly activity is taking place offshore, where the levered assets financed with low $U.S. lending rates reside, why worry? What's good for America is good for the world in the eyes of U.S. policy makers. This is giving the Chinese fits. All those trillions invested with the Bank of Bernanke could depreciate with the U.S. dollar if confidence flees. There's a good reason that the Indian central bank has just bought gold.

Our worry is not for the immediate future. Our belief that the economic rebound is intact and the revved up U.S. printing presses suggest financial assets will be well bid for some time. Our concern is the new speculative bubble building in the credit markets.

Perhaps ultra low interest rates won't work the next time the bubble bursts.

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