Infomail
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Every Central Banker for Himself

We are seeing the beginnings of an outright currency war that began in 2013 but is gaining steam in 2015. One only needs to look around the world and see it's a race to the bottom for currencies.

The latest central banks to cut were Australia (Feb 3: 2.50% to 2.25%), Sweden (Feb 12: Zero to -0.1%) and Canada (Jan 26th: 1% to 0.75%), joining Japan and Europe. With inflation virtually no threat (at this time!) it gives central bankers around the world the leeway to drop interest rates to try to stimulate their economies via lower currencies which hopefully lead to higher exports. But given basic accounting, not every country can win this "race to the bottom."

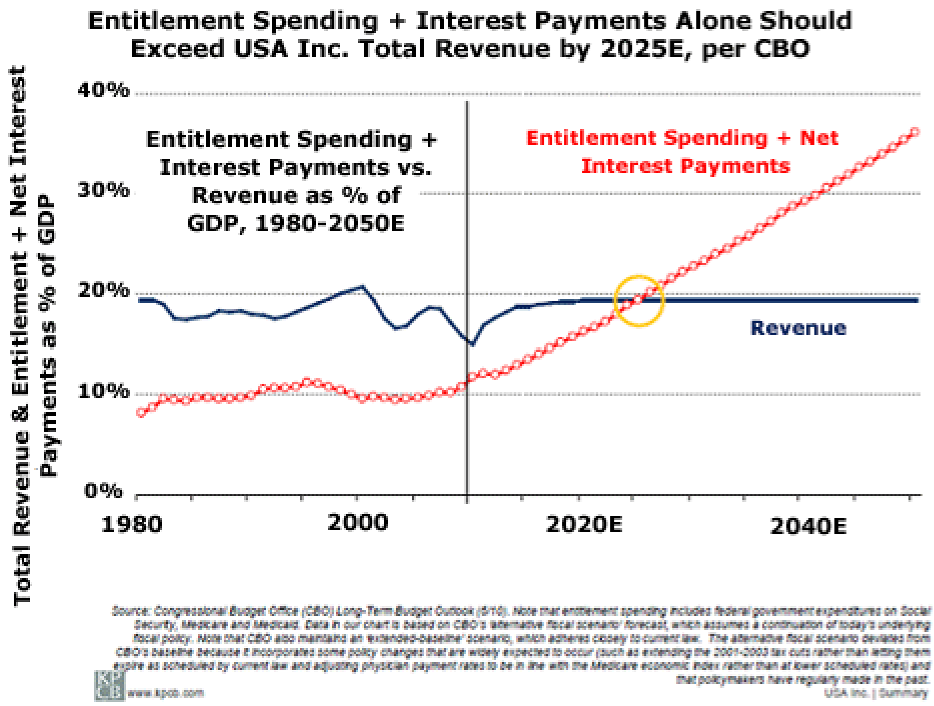
Demographics are decidedly deflationary. Every country in the developed world is getting older, and this trend has reached crisis points especially in Japan and Southern Europe. Each year there are fewer people in the workforce to support those in retirement.

The Japanese have been weakening their Yen for several years now, in an attempt to get out of the deflationary spiral they've been in since the early 1990's. And last quarter, they finally had a decent GDP number not seen for decades.

In Europe, ECB head Mario Draghi is committed to weakening the Euro. The reigning philosophy is that it boosts exports and thus growth. No other nation has been a bigger beneficiary of a low Euro than manufacturing giant Germany, whose economy is booming and unemployment near all-time lows.

This despite most developed governments around the world running huge deficits. France is at a 4% deficit, Germany less than that but Japan at a mind boggling 8%, even with a debt load of 250% of GDP!

The USA is at about 6% driven by their entitlement spending problem brought on by the current administration. At the current pace, in less than 10 years, the 3rd largest expenditure of the US government will be its interest expense (The others? Entitlement programs of course!). Social Security, Medicare and Medicaid are already two-thirds of the national budget and rising.



But while all other major global economies seem keen to keep stimulating and keeping rates low, the US Federal Reserve has made suggestions it is ready to hike rates, and even though they may want to, they might not be able to for fear of upsetting the global balance, a higher (still) US dollar which hurts US multinationals, and how a market "addicted" to constant stimulus is going to react?

Sometime soon, I would guess markets will realize we get to a situation where monetary policy no longer works.

Let's face it, if QE1 had really worked, would we have really needed QE2, or QE3 and QE4 for that matter? Logic would say no.

Assume the Fed raises rates in 2015. The economy is already fragile and lethargic. If recession reappeared (with rates already low), what would dropping rates back to zero really accomplish?

The velocity of money in the USA has been dropping for almost 10 years and is at its lowest level since WWII, but that can't be blamed on lack of monetary policy by central bankers. No, I would look more towards poor (if any) fiscal policy out of poorly run government administrations who believe big government is the answer to all woes.

For Keynesians, it can't get any better than it has, it's been their Golden Age of monetary policy if you will (i.e. free money and low rates) but the results have been far less than the textbooks would suggest.

So over the next year or two, monetary policy will NOT be the major driver of financial markets, than what?

While I still believe interest rates will remain historically "lower for longer" because the normal cyclical triggers for higher rates (inflation, unemployment and capacity utilization) do not yet signal a rate hike. US unemployment is at 6.0% or so, just below the previous cycle peak of 6.3%.

The financial crisis of 2008-09 scared the lives out of most central bankers when it looked like every bank in the world was going broke. So I would guess they will be sure the economies could stand on their own before they removed the training wheels and they will err on the side of caution.

Every economist educated since the early 1980's, a period of high inflation and even higher rates, still believes the main goal of monetary policy is price stability and that every central banker's worst nightmare is being behind the inflation curve. In fact, one could argue many of them desire some inflation at this point in combination with accelerated GDP growth.

Paul Volcker, perhaps the greatest central banker ever, was in charge of the Fed when I entered the financial world in the early 1980's. He tightened rates in 1979, 1980, 1984 and 1986 to get ahead of cyclical rising inflation, which peaked at about 13% in 1980-81. Yet Mr. Volcker still raised rates until early 1982, and it wasn't until August 1982, two years AFTER inflation peaked that he began to ease. His goal was not only to bring inflation down and keep it down, but to make sure it NEVER accelerated again. And for over 30 years, it has remained in that mode.

Now flip that around and instead of battling the demons of high inflation, today's central bankers, after the deflationary trauma of 2008-2012, that deflation is the new enemy and so to avoid that period again, today's central bankers are following the same course as Volcker, but in the opposite direction. So now they are waiting for proof of accelerating, sustained, economic growth before they can even consider tightening and raising rates.

Last week's release of the Federal Reserve's FOMC minutes showed a split group, almost afraid of raising rates.

These actions (or inactions) could have grave implications down the road, especially given rising debt levels, but rightly or wrongly, this appears to be the policy adopted by those in charge of the Fed, the Bank of Canada, the Bank of England, the Bank of Japan and the ECB, so expect any rate increases in the interim to be nominal.

Right now, equities remain the only alternative, but the investing crowd remains cautious. Euphoria is nowhere to be seen, so I think we still have a long way to go. Doesn't mean we can't get sharp corrections along the way, but the overall trend remains higher.

Governments around the world need to make some truly dramatic structural changes on their own before the markets do it for them. Greece's current issues proved Maggie Thatcher right about liberals and socialists spending "other people's money" until they run out of it. Now the markets and the bond vigilantes have taken over, and there is no good ending for Greece.

I don't think the political will is even close to where it should be, and that's what worries me the most going forward. But I've learned in those 30+ years that the US economy can absorb a great deal of punishment brought on by global events and even, yes, mismanagement.

With the upcoming US elections in 2016, there will be an opportunity to change the currency course they are on. Another axiom I've learned in those decades at this desk, is never bet against the USA.

Stay tuned,

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