The Central Banks Take Action

Investment Strategy Group
Market Update
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The last two weeks have witnessed significant activity from the world's major central banks, particularly the European Central Bank (ECB) and Federal Reserve (Fed). We're particularly impressed with the ECB's new asset purchasing program, the Outright Monetary Transactions (OMT). While further bond buying will not alleviate Europe's structural problems, it does mitigate the near-term risks and provides a window of opportunity for European politicians. On the other hand, the Fed's program is likely to have only a fairly modest impact on the underlying economy. Instead, its biggest impact may be on gold.

Europe: Stumbling Towards Integration, but Not There Yet

Over the past month, a lot has gone right in Europe. First, the ECB committed to an open-ended scheme, the OMT, to buy short-term European debt, which had the desired effect of lowering borrowing costs for Spain, Italy, and Portugal. There was additional good news last week when the German Constitutional Court upheld the constitutionality of the European Stability Mechanism, or ESM, which will become the principal fund to help struggling European countries.

Finally, the market also dodged a bullet when the Dutch election produced a market friendly outcome, keeping the Netherlands clearly in the pro-European camp. All in all, many of the near-term risks have been avoided.

That said, it is important to emphasize that Europe is not out of the woods, and the major structural reforms have yet to be implemented. In general, we see three main areas where European politicians need to deliver: tighter fiscal integration, labor market reforms, and banking reform.

Banking reform is of particular importance. In order to stem the bleeding of deposits from southern European banks, Europe needs to move towards a single European bank regulator and also some system for European-wide deposit insurance. Even if ultimately successful, these reforms will take time.

In the meantime, we remain cautious on southern Europe, which we still believe is "cheap for a reason." However, we continue to see good opportunities in the northern part of the continent.

We came into the year with overweight views on Germany and the Netherlands and added Norway early this year. Our view on Norway was driven by several factors, including its independent currency – Norway is not in the Euro – strong economy, high yield, and exposure to the energy sector.

While all of these markets have posted strong year-to-date gains – Germany is the standout with a 25% YTD gain – they still appear reasonably priced. All three countries are trading for roughly 10x forward earnings, a significant discount to US equities.

And for yield hungry investors, all three are yielding above 3%, and over 4% in the case of Norway (see Figure 1). So for now, we'd continue to generate our European exposure with a northern-bias.

While the program should keep a lid on bond yields, European politicians still need to address the structural challenges facing Europe. In particular, we see three main areas that need to be addressed: a plan for further fiscal consolidation, structural and growth initiatives, and banking integration.

The latter is the biggest near-term worry. Until there is a functioning EU-wide banking system in Europe, complete with some version of Euro-wide deposit insurance, a Euro in a Greek bank will continue to be worth less than a Euro in a German bank. Whether or not political realities allow politicians to meet these challenges is still an open question. But for now, the ECB has helped mitigate one of the biggest sources of systemic risk to the global economy.

Figure 1

Northern Europe Valuations vs. United States

	P/E	P/B	Dividend Yield
S&P 500	12.67	2.00	2.32%
Nasdaq	14.71	2.44	1.34%
Germany	10.45	1.28	3.84%
Netherlands	9.81	1.12	4.06%
Norway	10.2	1.39	4.53%

Source: Bloomberg 9/21/12. P/E is price-earnings ratio. P/B is price-to-book ratio.

QE3: Better for Gold than the Economy?

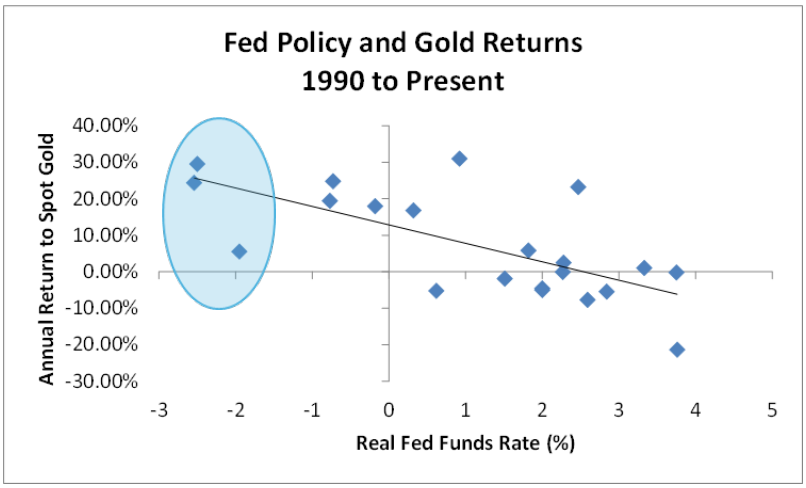
The Fed's decision to expand its asset purchase program with an open-ended commitment to purchase $40 billion/month in mortgage-backed securities was a fairly aggressive step. Coupled with the announcement to extend their guidance on holding the Fed Funds rate between zero and .25% until mid-2015, it suggests the central bank continues to be extremely concerned with weakness in the labor market.

Following the announcement, the market obliged with the obligatory "risk-on" rally. The rally may last longer, but other than providing additional liquidity to an already flooded banking system, it is not clear that QE3 will change much. The prospect of unlimited buying of mortgage-backed securities will help keep mortgage rates low, but it is important to remember that rates were already low. In July, a conventional 30-year mortgage could be had for 3.75%. It's not clear that a potential 50 bps or so reduction in mortgage rates will spur a housing renaissance. While the housing market is clearly on the mend, it is going to be a long convalescence, and there is probably little the Fed can do to expedite the process. At this point in the cycle, monetary policy alone cannot address the economies biggest challenge: a fragile consumer struggling with too little income growth and too much debt.

The Fed's actions – coupled with similar programs in Europe and Japan – may not change the economic fundamentals, but it may continue to support the "risk-on-trade" (assuming we can avoid the fiscal cliff) – particularly for commodities.

Historically, the most significant driver of commodity returns has not been the absolute level of inflation or changes in the dollar – the two factors investors typically focus on – but the level of real-interest rates. This has been particularly true for gold, which has, at least historically, been the biggest beneficiary of low real rates.

Figure 2



Source: Bloomberg 9/21/12.

The argument is not hard to understand. In an environment in which real rates are very high, as was the case in the mid-1980s, there is a huge opportunity cost to holding gold. Conversely, when real rates are low or negative as they are today, there is no opportunity cost in the form of foregone interest. Historically, this relationship has been so strong that since 1990 the level of real rates – measured by comparing the Fed Funds rate to core inflation – explains roughly 45% of the variation in gold (see Figure 2).

Given the Fed's recent announcement, investors have an unusual degree of visibility into future monetary policy. In the absence of a slide into Japanese style deflation – which is looking increasingly unlikely with inflation expectations actually rising – real rates may remain negative for many years. Given this prospect, while the Fed' s actions may have only a small impact on the economy, they may yet prove a much bigger deal for commodity and gold investors.

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