May 24, 2013

"I worry about the effects on the long-run stability of our financial system if the Fed attempts to substitute its judgment for those of the market. Such a regime would only increase the unhealthy tendency of investors to pay more attention to policymakers' attitudes than to the economic fundamentals."
-BEN BERNANKE, October 15, 2002, one month after he had joined the Fed.

POINTS TO PONDER

1. Even before shale gas production went viral, catalyzing the substitution of clean-burning natural gas for grimy coal, US air pollution levels were falling. As the gas boom has gathered momentum, so has the decline in the air pollution index. (*See Figure 1*)

2. Investors are once again wondering if all that glitters isn't everything except gold given its latest face-plant. Yet, in addition to feverish buying by Asian consumers, large commercial institutions are also aggressively accumulating the yellow metal. Although their track record isn't perfect, it is impressive. (*See Figure 2*)

3. Supporting the thesis that the US is indeed in the early stages of an industrial renaissance, America's manufacturing sector has risen as a percentage of the total economy for three straight years. While it's the first time this has occurred since WWII (per Ned Davis Research), a factor behind this could be the fitful nature of our recovery from the Great Recession, which has crimped many other parts of the economy.

4. Showing that Congress continues to lead from behind, and is otherwise lagging the rationality curve, the appetite for introducing desperately needed budgetary reforms has waned thanks to a sharp drop in this year's projected deficit. Unfortunately, scant consideration is being given to the non-recurring nature of this improvement, such as a surge in tax payments due to income acceleration at the end of 2012, to beat higher tax rates. Large repayments from Fannie and Freddie are also unlikely to continue at recent levels.

5. Reinforcing the danger of the aforementioned cluelessness on the part of our elected representatives, bond guru Jeff Gundlach observes that if interest rates normalize by 2017, total annual US government debt service will amount to $1.5 trillion. Given that aggregate federal tax receipts are "just" $2.5 trillion currently, this aspect alone is assured to keep deficits extremely elevated. (*See Figure 3*)

6. Although the April durable goods order number was encouraging, the trend over the last few years remains down. Given that orders tend to be a leading bellwether of manufacturing robustness, or the lack thereof, this pattern does call into question the upbeat economic views routinely espoused by various high-profile media types. (*See Figure 4*)

7. In another sign that stocks are far from undervalued, well-known financial newsletter scribe Richard Band notes that the S&P 500's prices-to-sales ratio is 1.5 to 1, almost 60% above its average since 1955. This ratio is calculated by dividing the overall market value of all companies in the S&P by the economy's total activity. It is one of the cleanest ways to determine if the market is cheap or dear, as it is not distorted by the profits cycle.

8. Regular Barron's columnist Kopin Tan, also quoting Ned Davis Research, observes that never before has there been less cash on the sidelines as a percentage of stocks and bonds outstanding. This includes the major market peaks of 2000 and 2007.

9. One huge impediment for the US economy is the intense lack of confidence on the part of small businesses. This is what renowned historian and economist Niall Ferguson refers to as the Rule of Lawyers (and Bureaucrats) effect. It's reasonable to expect this condition to worsen in the months ahead as the 20,000-page Obamacare beast comes out of its cage. (*See Figure 5*)

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10. The confusion over climate change can be illustrated by two seemingly contradictory facts. On the one hand, carbon emissions are up 50% since 1997. On the other, global temperatures have remained essentially unchanged in this period. (*See Figure 6*)

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11. Global central banks are apparently not satisfied with indirect infusions of trillions of synthetic money into the world's financial system. According to a recent Royal Bank of Scotland survey, 23% of these institutions reported that they are directly buying stocks, or plan to, including the once staid Swiss National Bank.

12. Lost in the feel-good aura, caused by the ECB's mostly verbal efforts to suppress interest rates in Southern Europe, is the fact that 30% of the money pledged to bail out distressed countries is supposed to come from Italy and Spain. Moreover, another 20% is allegedly to be provided by France, which has rapidly rising fiscal challenges of its own. (*See Figure 7*)

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13. Japan, long the developed world's chronic growth laggard, just announced GDP expansion of 3.5% for the first quarter, giving the rest of its rich-country peers a dark-green case of envy. While this is a graphic illustration of what trashing your nation's currency can do to goose short-term vibrancy, sustainability will be the key challenge. The acute need for growth-nurturing reforms is underscored by the fact that Japan ranks 114th in the world in terms of the ease of starting new businesses, according to the World Bank.

14. Past EVAs have noted the relatively small gold holdings of the Bank of China (BoC). Lately, though, it seems to be determined to change that status. The BoC bought 371 tons in the first quarter of this year alone, a 170% increase from Q1 2012.

15. There are growing concerns about escalating debt levels in China. However, despite these legitimate concerns, its hoard of foreign exchange reserves is a significant pillar of strength. (*See Figure 8*)

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He said what? As hard as it is to believe now, with US stocks setting new highs on a daily basis, only four years and three months ago global financial markets were seemingly headed for extinction. In February of 2009, one of Evergreen's most devout clients asked me if I was sticking by my January prediction that the market would finish higher for the year. With stocks already down 18%, and the trend decidedly negative, I would have jumped at the chance to change it. Yet, as I pointed out to him at the time, a forecast is a forecast.

Now, I'm in a similar prediction predicament. Only this time, it's due to my call for a roughly flat market this year as the S&P rips higher. If I could, I'd be dumb not to change that to a 15%, or even 30%, up-year forecast. Or would I?

In the February 15th *EVA*, I mentioned that if this market did continue to fly it might start to resemble what we saw in 1987. Yes, I really am old enough to remember that year—in all the gory details! In fact, I had been "in the business" for eight years when the October crash occurred.

Back then, portfolio insurance and program trading were all the rage. The assumption was they added liquidity and made the market less volatile (hmmm, sounds a lot like the rationalizations for flash traders, armed with their lethal algorithms, these days).

For those too young to remember, 1987 was the fifth year of an incredible bull streak. A market that already was up 171% from its 1982 bottom by the spring of 1987 proceeded to rise another 21% over the course of the summer. Problems like rising interest rates and a weakening dollar were blithely ignored. And then came October, with portfolio insurance and program trading at the epicenter of the worst crash since 1929.

As that month taught us, and numerous other market wind shears have since, stocks have a nasty tendency to go down much faster than they go up (latest case in point: Japan this week). Consequently, it may be a bit premature for me, or anyone else, to assume that the market will indeed finish up for the fifth straight year and in double digits to boot.

It goes without saying, though, that I wish we weren't as defensively positioned this year as we have been, at least on the stock side of our portfolios. Conversely, our income portfolios have been extremely well situated, despite some hedges, to take advantage of another year of investors desperately seeking yield. This is one reason, among many, that we have elected to be more risk-averse with our growth holdings.

Unquestionably, the central banks are in command right now and they are feeling the market's love (whatever happened to all the Fed conspiracy theorists and their bible, *The Creature from Jekyll Island?).* One of the more memorable observations I heard at the recent Mauldin/Altegris conference was from Niall Ferguson talking about a conclave of central bankers he had just attended. He was appalled by how smug they all seemed. Call me paranoid, but I don't think hubris in high places is a good thing, especially when it involves the people who have the keys to the printing presses.

The others who are strutting a bit right now are the ultra-Keynesian economists like Paul Krugman who believe their thesis of unlimited money creation has been vindicated. Excusez moi, but I don't think this camp should start taking bows until we see how the markets and the world's economies perform once the pseudo trillions are removed from the system.

Yet, the one person who above all should be feeling his oats right now seems to be having a few

second thoughts. As noted in last week's *EVA*, Ben Bernanke, the magician-in-chief behind "large-scale asset purchases" (i.e., using smoke and mirrors money to buy government securities), recently issued a warning about investors ignoring risks.

Could it be that Dr. Bernanke is starting to feel a bit like another doctor right about now—as in Frankenstein?

Einstein's theory of insanity. In this week's congressional testimony, Dr. Ben, who normally prides himself on clarity and transparency, brought back some not-so-fond memories of his obfuscating predecessor and mentor, Alan Greenspan. His warning about premature tightening, followed by somewhat contradictory comments indicating the Fed might "taper" soon, disappointed the stock market (as did Fed meeting minutes that mentioned possible backing off as early as next month). The net result was a 270 point reversal in the Dow on Wednesday.

While he may revert to uttering soothing words in the days ahead, this is the second time in a few weeks that he has thrown a bit of cold water on the white-hot stock market. Could it be that he's becoming increasingly wary about a repeat of what happened in 1987, when Mr. Greenspan was in his first year at the Fed?

Dr. ~~Frankenstein~~ Bernanke may realize it's time to do his reprise of Mr. Greenspan's famous "irrational exuberance" routine from 1996. (Of course, the Maestro didn't back up his talk with anything concrete, like raising margin requirements, and exuberance morphed into mania.) Our current Fed head is smart enough to realize that if this market should go vertical from here, a replay of the 1990s' melt-up/melt-down, or the earlier 1987 fiasco, is extremely likely.

Moreover, Dr. Ben certainly doesn't want a stock market version of the housing debacle to further sully his once impeccable resume. Despite his outward equanimity, he must be getting just a wee antsy about the prospect of Bernanke Bubble 2.0.

He also can't be that enamored with a lackluster economic recovery. Consequently, it's possible that he may seek to shift "QE Infinity" into a gear that would have a more direct impact on Main Street and much less on Wall Street.

In this regard, a growing chorus of economic pundits feels the Fed should drop its fig leaf and shift into naked bond monetization. This would mean it would buy debt directly from the US Treasury instead of using those pesky banks, like ~~Jamie~~ J.P. Morgan, that seem to have such a hard time getting the dough to circulate. As we all know only too well, the Treasury excels at spending money as soon as it gets in the door—not to mention another trillion or so more (yes, I realize the deficit is now down to a mere $600 billion, give or take, but let's see how long that lasts).

Realistically, the odds are probably against this scenario becoming reality, which would have its own set of negative consequences. However, I believe that some kind of a mid-course correction by the Fed, to a tack other than trying to pump up asset prices, is becoming more probable.

Of course, the new plan could be to, as Emeril Lagasse likes to say, "kick it up a notch" by cooking up even more BBBs (Bernanke Bubble Bucks). Dr. Ben did seem to relish pointing out to his congressional interrogators that Japan's money blitz is much greater relative to the size of its economy, and that it appears to be reviving growth. However, pouring more lighter fluid onto an already overheated US stock market would almost certainly lead to a spectacular burst and

the inevitable flame-out.

What lies ahead, no one knows. However, I believe that one of two paths are likely: Either the Fed stays on its present path and we get 1987 revisited—with a bull becoming a bubble, followed by the big pop—or it tries to gracefully exit stage left, triggering a more immediate but much less painful "adjustment." Certainly, the price action over the last few days indicates just how addicted markets have become to the Fed's continual fixes.

Until lately, almost everyone assumed that there was no end in sight to the Fed's artificial highs. Now, with a whiff of methadone in the air, the prospect of going cold turkey is causing some cold sweats. The sooner the markets get the Fed's monkey off their back, the sooner they can get clean and sober. As with a junkie, there's no time like the present, but, unless the bond market steps up, I'm not sure who will force the intervention.

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