

August 2011 Alvine Newsletter

Markets versus Politicians

Or Markets versus Politicians and Central Banks

'Blessed are the young for they shall inherit the national debt' Herbert Hoover
(brainyquote.com.)

A summer crisis has blown up over Government debt levels on both sides of the Atlantic. While the origins may have been in peripheral Europe, the US's own fiscal world of make believe has been rumbled by S&P.

For the US's Treasury Secretary to so arrogantly brush aside this downgrade leads to little confidence that the lessons of fiscal, political and military tape out have not been learned.

Alvine did not see the extent of this crisis coming, and hence before commenting further must issue a *mea culpa*. The vigorous economic recovery in Western economies had already petered out when the fiscal crisis hit. This has now led to a crisis in consumer confidence that will inevitably affect consumption patterns, and hence the economic numbers of the next few months. With this week's stock market collapse a double dip recession must now be likely in the main G7 markets. Equity markets have a habit of predicting where economic trends are heading.

That was the bad news. At Alvine we are gratified that our other main forecasts for 2011 appear to be well founded, with the US \$ firmly entrenched in a bear market and commodities suffering a real blow out low. Nymex crude is set to close at our year end target of \$85 per barrel.

Reason to be cheerful

1. **Commodity drag over**—higher prices in the early part of the year, especially for gasoline, were one of the reasons that consumer demand came in weaker than we expected. This pressure has been alleviated, which will make a big difference in the US.

2. **Short rates on hold**—at the beginning of 2011 many economists had begun to factor in the unwinding of Central Bank asset sales and/or a gradual tightening of short rates. This is off the table to at least 2nd H 2012.
3. **Value**—with equity markets falling, Treasury yields plummeting and short rates near zero valuations are at the lowest level in a generation. Importantly this is not just P/E ratios but dividend yields too.



S&P 500 dividend yield vs 10year treasuries and libor (source Bloomberg.)

Dividends now yield more than government bonds and multiples of short rates.

4. **Enter the Fed**— expect more QE, and this time it will be coordinated between G7 members.

‘High noon between Politicians and Capital Markets’ so writes Dynapartners. It is indeed an interesting question when the best laid plans of democracies collide with uncomfortable questions being asked by markets. As James Carville (Bill Clinton’s political mentor) mused, he would like to come back in a next life as the ‘bond market, you can intimidate everybody’

(WSJ 25/2/93.) For the UK during the ERM crisis in 1992, Russia's 1998 default and many other times when politicians unrealistic plans were overwhelmed by reality.

But this time it's different. The Federal Reserve, ECB, BOE, SNB and the BOJ all have control of the printing press. As they have all already passed the Rubicon and engaged in various acts of money creation. The only question is whether they still have the will, and the political cover to continue.

If you doubt at least Chairman Bernanke's resolve we would direct you to his famous 'helicopter speech' made almost ten years ago-
www.federalreserve.gov/baorddocs/speeches/2002

With all major economies in the same boat a collective decision is likely to assuage the critics.

For this reason we remain confident that high quality equities represent a good long term investment. Where we would differentiate is to steer well clear of financial and commodity stocks.

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