

## Thought for the Week: Monday, November 1st, 2010

### Three “Must-See” Events for this Week

This week brings **three events that could have a profound effect on major markets** over the next six months or more. Before we discuss each, remember markets don't always perform as we might expect. Oftentimes, good news causes a fall in prices, as the good news was widely anticipated and priced in. The opposite can also occur. Additionally, investors, and therefore indices, are generally trying to price what happens in the future, not price what has already happened. **Most asset managers will be polishing their crystal balls this weekend, ready for a busy week.**

#### Tuesday, November 2<sup>nd</sup> - Elections

Conventional wisdom points to a resounding swing towards the Republican Party, and/or its English-sounding, beverage-named splinter group. This would be interpreted as a no-confidence vote in the incumbent leadership's handling of the economic crisis and **possibly prescient of a loss of power in another year or two.**

In our view, what is needed is 'Old-School' leadership; someone who isn't scared to stand up and sell the need for austerity. Unfortunately, both parties will probably be forced to support the printing of money as neither will want to be accused of halting the recovery. Imagine if the Republicans used their new-found power to veto spending bills and unemployment kept rising. The Democrats would have an immediate scapegoat to blame for the current situation. As the great old school politician, Winston Churchill once said: *“democracy is the worst form of government except all the others that have been tried”*.

Much of the above is **already priced into current markets** and therefore election results corresponding to expectations should not have too much bearing on markets beyond the next week or so. Ignoring the political implications, once the dust settles, **won't the current administration step up their efforts to reinvigorate the disenfranchised consumer?** Which leads us nicely onto QE2...

#### Wednesday, November 3<sup>rd</sup> – Federal Reserve (FOMC) Meeting

**Investors will be looking for clues from the Fed** regarding two factors: Quantitative Easing Two and The Currency Wars (see recent Thoughts for more background):

- Markets have priced in a significant Fed commitment to QE2; anything less may be a letdown. Last week saw approximations as to the possible size of QE2.1 (the first round of QE2) and the market wasn't impressed. **If the Fed wishes equity, bond and commodity markets to keep moving forward**, they'll have to indicate that they are prepared to write some significant checks.
- Competitive Currency Devaluation is an inherently unstable system. Someone must lose their share of world trade in order for others to gain. Moreover, a policy of boosting exports by **financial manipulation can all too easily turn into a policy of blocking imports**. An announcement of policies which further devalue the dollar will bolster those who say the Bretton Woods II 'Core & Explore' monetary system, with the dollar at its core, is coming to an end. As the great financial luminary, Prime Minister Papandreou of Greece recently wrote: "Democratic governments

worldwide must establish a new global financial architecture, as bold in its own way as Bretton Woods”.

Okay, so here's the bottom line: We are experiencing a period which is confounding many economists; **a period where interest rates are low and the money supply is excessive but the consumer refuses to be stimulated.** When the Government is falling so far in debt in order to keep printing money and keep interest rates so low, **how come the economy isn't more buoyant?**

This is normally referred to as a **“Liquidity Trap” and contains the concept of “Infinite Elasticity”.** Infinite Elasticity means no matter how much money is pumped in, demand refuses to rise.

- **Long-term**, we are looking to the Fed to either solve, or propose some form of solution to the current liquidity trap. Continually writing checks will not work in the end. If Chairman Ben proves to be a one-trick Donkey, he may leave behind a considerable mess when he leaves the stage. It is hard to argue, and difficult to find anyone who will argue, that the current Fed fiscal policy isn't just inflating prices, especially bonds.
- **Short-term**, anything less than implicit commitment to an aggressive launch of QE2 may disappoint markets.

How can the Government recapture the hearts and minds of the electorate while the economy is not generating employment and consumer wealth? Which logically brings us to...

### **Friday, November 5<sup>th</sup> – Employment Numbers**

Wouldn't it be nice for everyone if Friday's Jobs Report announced a fall in unemployment? In our view, the recent declarations regarding QE2 and Currency Wars have been motivated, to some degree, by Government knowledge that employment isn't coming back as quickly as needed.

While our job is to look at the range of possible outcomes and prepare for each, **we have a hunch that Friday's report will not bring much cheer.**

Large multi-national employers have used the recession to increase productivity, aka reduce labor, and move operations further overseas to where the growth and currency strength resides. We need **small and medium sized companies to pick up the employment baton; a tough call while the banks keep most of the QE1 money to themselves.**

If anyone has recently tried applying for a business loan, we'd be interested to hear your experiences.

Scary stuff...which only leaves one thing to say:

**We hope you and your family  
enjoyed Halloween!**

