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QE2 - economy overboard

"Over the medium term, participants saw both upside and downside risks to inflation."

- Minutes of the US Federal Open Market Committee, once again boldly telling it how it is.

Optimism may well play a key role in human evolution and survival, but in matters of the narrower discipline of investment it can be a grave threat to the retention of wealth. Which is not to say that pessimism is preferable, only that the quest for realism – or objectivity – is likely to be the most rewarding route towards capital preservation and growth. This is a hard orientation for most investors, given that the financial services industry, and notably the ethical swamp that is the brokerage business, has an enduring bias in favour of good cheer. Bad news rarely sells.

But blind optimism now would be, in our view, exquisitely dangerous. The latest reason for a considered pause comes with publication of the most recent minutes from the US Federal Reserve. Fedspeak is a bureaucratic sedative at the best of times, but sometimes the dry-as-dust language is unable to conceal some real firecrackers. The minutes from the Open Market Committee of 22-23 June contain the following observation; it's interminable but bear with it:

"Participants generally anticipated that, in light of the severity of the economic downturn, it would take some time for the economy to converge fully to its longer-run path as characterized by sustainable rates of output growth, unemployment, and inflation consistent with participants' interpretation of the Federal Reserve's dual objectives [price stability and full employment]; most expected the convergence process to take no more than five or six years."

Couched in such bland and soporific prolixity, the point of that sentence may initially pass most readers by. Here it is shorn of its anodyne length and fussy circumlocution:

The US economy may not recover until 2016.

And this from a committee that is preconditioned to be on the side of the optimists.

Looking for the conventional and predictably upbeat Wall Street view doesn't take much time with modern technology. Just type 'Abby Joseph Cohen' into Google News and almost immediately you find that the Goldman Sachs permabull recorded message

"..is very optimistic that the recovery in exports and corporate investments will put the incipient recovery in the US economy on a firm footing..

"***We think the recovery here in the United States is quite solid***."

The Federal Reserve Open Market Committee would beg to differ, but then they're not in the business of promoting stocks (at least, not explicitly). The admittedly subjective assessment of the FOMC is not the only reason to be a little wary of the vigour of the apparent recovery:

- The Baltic Dry Index, a measure of shipping costs and a plausible barometer for world trade, has fallen by almost 60% in its longest streak of successive declines for 9 years;
- The Thomson Reuters / University of Michigan preliminary index of consumer sentiment fell from 76 in June to 66.5; consumer spending accounts for roughly 2/3 of US GDP;
- The Philadelphia Fed's July index of new manufacturing orders fell from 9.0 to minus 4.3;
- The US workforce has contracted by 1 million over the past two months;
- US mortgage applications have fallen by 42% to a 13-year low.

Goldman Sachs has just published a report entitled "Double Dip or Double Up ?" which, revolutionarily for a brokerage firm – albeit one masquerading as a bank – calls the bottom and advises investors to dive back in. We think the correct answer is unequivocally Double Dip and prefer the analysis of ICAP's Nic Lenoir:

"The silver lining is always the same: private GDP has collapsed, and governments around the world are trying to prevent us from falling off the cliff artificially via stimulus, quantitative easing, accounting gimmicks, or data distortion.. The day we get weak equities, weak commodities, weak US Treasuries, and a weak US dollar.. well that day you better start praying because it means gravity just woke up."

Lenoir suggests that commodities will show the way. For those, like us, who see defensive merit in gold, Zero Hedge suggests that the Paulson & Co hedge fund may have been liquidating some of its huge gold holdings to make up for losses incurred elsewhere. A correction in the price of gold would be, for us, a welcome opportunity to top up at lower levels, particularly if – as looks increasingly likely – central banks are preparing the way for a second round of quantitative easing, or QE2. The jury is still out on the first round of QE, not least because we will never know the counter-factual (what would have happened to the economy without it). But as the ever-sceptical Ambrose Evans-Pritchard points out for The Daily Telegraph, zero interest rates, $1.75 trillion of QE and a fiscal deficit above 10% of GDP have failed to deliver much for the US economy. This is the problem with QE: the reason your money doesn't buy so much is because of how much they're printing. QE represents the monetary law of diminishing returns, and is the single biggest reason to seek wealth protection in the form of unprintable precious metal.

Over recent weeks, the future has seemed (to us, at least) that much clearer: deflationary, with a Double Dip more or less a racing certainty. If this view turns out to be justified, then it supports arguments for the highest quality bonds, the most defensive equities (if equities at all), genuine 'absolute return' funds, and gold. Perversely, although the medium term outlook in financial terms seems once again challenging, there are some clear and, we believe, eminently practical investment solutions as a way through the woods. We could, of course, simply bang the 'recovery' drum, but

in the face of so much evidence to the contrary, why bother ? We can leave the conflicted and perennial happy-talk to the stockbrokers.

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