WALKERCRIPS
STOCKBROKERS

A PERSONAL VIEW FROM PETER BENNETT

QUARTERLY STRATEGY – PART II

Panic - QE^N

Policy is like an army on the run. The generals get the troops to spray bullets at random in the rough direction of the enemy. And pray one or two hit. Tough if they hit the retreating troops themselves. Basically, they have little clue as to what they are doing. And the results show it. Read on.

Distortions – to add to those in previous Bulletins

1. US Stocks per 'Q' and CAPE (Cyclically Adjusted Price Earnings ratio) are, according to Andrew Smithers, around 50% to 60% over-valued currently. Value is the most reliable estimate of long-term return. There is potential for massive ultimate losses. Near 'bubble' yet again.

2. US CCC (junk) Bonds are selling at their lowest yields ever. This grade actually yields over 9%. That's the good news. The bad? This year's default rate is 24%. Go figure. It is a desperate search for yield as Greenspan^3 sets up the possible wreck of the financial system. Or is it Greenspan^n? This would match my suggestion of many Bulletins ago that we might see QE^n. We do.

   Investment Grade Debt has been distorted down to yield less than 3%. This is a bubble which will ultimately deflate. Painfully.

3. Indexed Bonds are also in a bubble, with prospective negative real returns! Trouble in due course there is likely too.

4. The above symptoms are, of course, a direct result of QE^n. Whilst nothing to do with QE, but very much to do with distorting of financial reality, i.e. the predictable effects of the wretched euro – riots break out in many European cities and cross-border lending has almost dried up. The weaker economies are being strangled, if not actually imploding. The FT states political cohesion in Spain is crumbling.

5. In the US, capital investment as a percentage of corporate cash flow is at its lowest level ever since the war. Hardly surprising. Businessmen can see what's going on, as well as I can.

6. The Financial Times reports fear in the currency markets, as players struggle to find currencies that may not be manipulated downwards in a 1930s 'beggar thy neighbour' fashion, by central bank monetary excess. This excess also puts unnatural upward pressure on non-print nations, often emerging economies. If these economies then try to hold down their currencies, domestic inflation, consumer and/or asset bubble, are/is likely to result.

7. Commodity prices are probably higher than they would be without QE^n, as investors seek something of actual real value. Fine for the producers, not such fun for consumers, especially those on low incomes where food and energy take up a large slice.

8. Central Bank balance sheets, apart from being out of control, are gradually being weakened, e.g. having to own or underwrite financial muck. The Germans are ultimately in for about €1 tn of this.

In all this, Greenspan[3] has acknowledged that he is targeting equity prices. Despite the well-established history that shows rising stock prices (as opposed to residential real estate prices) barely have any effect on consumption at all. Hardly surprising, as stocks in the main are held by 'fat cats', who are not short of a bob or two regardless of the value of their stock portfolios.

Yes, it reduces the cost of equity capital. But there is no shortage of corporate cash (or bank lending capacity, for that matter) and artificially low capital cost typically leads to mal-investment.

The theme of all this is that QE^n has resulted in distortion, manipulation, mis-pricing of capital, and unethical and destructive transfers of income or wealth across the population (the gap between rich and poor widens yet further). Savers are financially murdered. And 'moral hazard' for the future goes ballistic. The creative **destruction** vital to freeish capitalism is denied, thus also denying the creative bit as energies, time, money are perverted to propping up rubbish.

To what result?

Nothing to date. Of permanent nature at any rate. Indeed, the more the QE the more the world economy has actually slowed down. Arguably not wholly cause and effect – though partly so for all the reasons I have listed, that destroy confidence.

Why?

To prevent the mountain of bad debt going where it belongs – in the financial incinerator.

The politicians are ruled by fear of the short-term pain of putting such a policy into effect. They disregard how successful such a policy has been in the past e.g. as readers know, Asia (late last century "Asian crisis") and US 1920 / 2. Fear rules.

And yet the delusional 'experts' queue up to praise Bernanke. Probably the same lot who queued up to idolize 'Maestro' Greenspan and our Brown.

If indeed the 'Asian crisis' / US 1920 – and many other occasions before the likes of Greenspan came on the scene – policy had been followed, there is every chance that by now, five years (for heaven's sake) after this mess exploded, we would be on the way to cleaned up and sustainable recovery. In that analysis QE^N is **already a failure** and the story has barely begun. **Five years in**.

All in all a quite unbelievable mess – disguised for the moment by the toxic / narcotic effect of QE^n.

Investment

Don't fight the Fed

The mantra peddled by stock salesmen. Sounds good. But rubbish – or rubbish enough to be meaningless. As this bulletin pointed out at the time, fighting the Fed was the winning policy in 2000/01 and 2007. I have <u>not</u> suggested it since as I guessed the Fed panic would be so large as to convince those desperate to be convinced. It has been. So far.

The long-term saving grace for investors is the cheapness of European and Japanese shares. Nevertheless, how the valuation gap between Wall Street (a dominant market) and these can be closed or finessed without ructions, I do not know. It is possible a little smart trading will be needed.

Clients will have seen a high portfolio percentage of what I would call **middle grade corporate debt**. This sector has also started to become a bit too popular. The situation needs monitoring.

Gold

I doubled up a few months ago when the price fell sharply. This too has again become a bit fashionable recently. There is, nevertheless, no reason currently that I can see to abandon all of the twelve year bull position.

Cash

The most unpopular place currently? A good reason in itself to have a significant holding – apart from the obvious ones that fall out from my general analysis. In due course there should be some fantastic opportunities for those with the firepower.

Lastly

Inflate or die or inflate and (financially) die – as the ultimate debt 'solution'?

Impossible to tell – but a tad unnerving.

Good luck.

Peter Bennett, BA Cantab, MBA Wharton
September/ October 2012

Finsbury Tower, 103-105 Bunhill Row, London EC1Y 8LZ
020 3100 8000 | client.services@wcgplc.co.uk | www.wcgplc.co.uk

Disclaimer

This research cannot be classified as objective under Walker Crips Stockbrokers Limited's ("WCSB") research policy (please see our Website www.wcgplc.co.uk for more details).

While WCSB use reasonable efforts to obtain information from sources which it believes to be reliable, it makes no representation that the information or opinions contained in this document are accurate, reliable or complete. Such information and opinions are provided for the information of WCSB's clients only and are subject to change without notice. This document should not be copied or otherwise reproduced.

WCSB and any company or individual connected with it may have a position or holding in any investment mentioned in this document or a related investment. Nothing in this document should be construed as an offer or solicitation to acquire or dispose of any investment or to engage in any other transaction. The value of investments and income arising from them can go down as well as up. Movements in exchange rates can have an adverse effect on the value, price or income of any non-sterling denominated investment. Past performance is not a guide to future performance. If you are in any doubt as to the suitability of any recommendation contained within this document, you should consider your investment advisor.

This document is issued by WCSB. WCSB is authorised and regulated by the Financial Services Authority and is a member of the London Stock Exchange and APCIMS. WCSB is a member of the Walker Crips Group plc and is registered in England. Registered Office: Finsbury Tower, 103-105 Bunhill Row, London EC1Y 8LZ. Registration Number 4774117.