Perchance to dream… - March 7th 2015

This week has seen an acceleration of dollar strength, and its opposite, emerging currency weakness, along with a further rise in the yield of US Treasuries. Gold has been given another bath and has closed under $1,200. The euro has taken the brunt of western economy currency weakness, ending the week at a 12 year low, yet European stock markets are on a tear. The uptrend in US equities is still very strong and US unemployment is approaching the "natural rate", which is in the low 5% range.

These are just a few of the many variables we have to factor in to our assessments of the global economy and financial markets and where to invest our money. That there are more opinions than there are inputs says much about the statistical probability of successful forecasting! We just don't know with any accuracy what is in store, other than that buying value on a long term basis is the only strategy worth pursuing over the long term.

And where is the value today? If you turn over a few rocks in unlikely places you might find a morsel or two, Japanese REITs maybe or some of the junior gold miners, but where is mainstream money going to find a home? When you can't determine the risk free rate of investing with any certainty because central banks have manipulated the rate via QE or just plain skullduggery in the LIBOR "fixings", then it becomes even more dangerous to make assumptions. The rate proxy used to be the yield on 10 year Treasuries and given the explosive rise in said yield this week it may be making a comeback!

The spread between Treasuries and Bunds is at a significant high and should be corrected shouldn't it? Well maybe not a while. The ECB in its "infinite" wisdom (they are subject to the same statistical probabilities of success as we mere mortals) have decreed that buying sovereign bonds down to yields equal to the ECB facility rate of minus 0.20% is allowable. So with 10 year Bunds currently yielding a positive 0.40% there is still a way to go! Along with a continuing decimation of the euro, which is driving up the cost of imports for those forced down the austerity road while giving a free ride to the major exporters, the champion which just happens to be…wait for it…Germany!

Like so many things today, it just doesn't make any sense does it? The rise and rise of the dollar has been reinforced by comments from she who must be listened to at the Fed (repeat observation about statistical probability at least twice in this case for emphasis…) that their "patient" stance on the slow economic recovery may well transform into "OMG have you seen the unemployment numbers" by the middle of the summer and we have the first rate rise. This is causing havoc in emerging economies, and others closer to home (Austria anyone?), with huge dollar loan obligations that are getting harder and harder to service – shades of 1994? In the short term there might be a pause for breath, but longer term history suggest that when the dollar gets moving it can travel a long way. But what might impede its progress?

It is hurting countries with a dollar peg and the significant "other" in that scenario is of course China. Might they let the peg go? Well they will have to at some time and the “lets abandon the dollar as the global reserve” rhetoric is gathering more adherents. A recent bill board in downtown Shanghai eulogised the yuan as the “next world currency”. China has been adding gold to its reserves as fast as it can go with the suggestion that some sort of gold backed currency would provide a very satisfactory alternative to the “worthless” dollar not to mention the quite “euseless” euro. Since Nixon abandoned the gold standard in 1971, fiat currencies have been running on borrowed time.

Why then is the price of gold falling? Well if you were a large central bank and all the items on your balance sheet were bits of paper and your “competitors” were swapping their paper holdings, mostly yours, for the barbarous relic, then wouldn’t you want to see the price fall for at least two reasons. Firstly to force people out of the only store of value left to them and secondly to accumulate that gold at a much lower price to make your balance sheet more respectable.

Central bankers understand value it would seem, but only when it suits them. This still doesn’t answer the question of where to invest today. Value managers are finding it increasingly tough, if not impossible, to find what they are looking for and equity markets are generally looking stretched although still in uptrends for the time being. Bonds, which traditionally have been the safe haven, risk-off investments in today’s parlance, are now taking on what looks like equity downside characteristics. Gold is being bludgeoned, but may be worth picking up in “baby steps” as it trends lower and commercial property, whilst not as expensive as its residential neighbour, isn’t cheap either. Oh that there were a yield from cash! “Perchance to dream, ay there’s the rub”.

Clive Hale –The View from the Bridge – March 7th 2015
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