SIS LIMITED

Synaptic Investment Services Limited

UNEASY MONEY

AMBITIOUS OBJECTIVES

A continued acceleration in economic growth, the housing market seemingly on the mend, no signs of despair across the pond for a few months and the crowd seems to believe it is time to taper the size of asset purchases by the U.S Federal Reserve.

Alas things are not as simple as that!

Compared to what we witnessed not long ago, the situation in global markets since the start of the year had been calm principally on account of extensive monetary easing (QE) by the US central bank (Fed) since last November. In recent weeks however, the permanence of this QE has been called into question thereby raising fears on the financial markets. Indubitably when the U.S sneezes, the world catches cold. We look under the hood at what is happening.

- The U.S budget deficit is massive and a rise in interest rates has an impact on long term sustainability
- They need investors to keep buying treasuries to fund this deficit and the Fed also buys to keep rates low
- The mortgage market is also struggling with affordability of loans an issue while refinancing is difficult for many due to negative equity on their home loans
- Inflation is below their target rate of 2%
- Unemployment is stubbornly high at 7.6%
- Vital fiscal action is compromised with Congress and Mr. Obama at odds

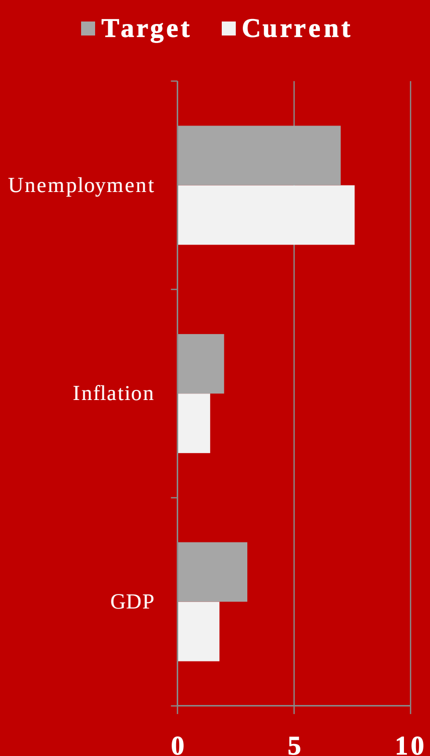
"QE has been an easy escape route in these circumstances with band aids being applied. But there are unintended consequences to which the FED is not oblivious but will not necessarily admit"

QE is done through primary dealers (large banks) and the Fed cannot control allocation of money. As we saw during the financial crisis, these large banks through the use of derivative instruments increased risks to the system by growing too big to fail. Interest rates are lowered across the spectrum which means cheap finance for high risk bonds and this distorts the risk – return balance for investors.

AMBITIOUS OBJECTIVES

Putting the cart before the horse…

….Is economic growth dependent on stock market growth or the reverse?



Easy money flows into other economies affecting their exchange rates, impacting on export sectors and creating complacency for countries with current account deficits. QE also boosts share prices with reduced quality differentiation in essence creating further pockets of instability

Monetary policy is in unchartered territory here and given that it has a significant bearing on growth and particularly asset prices, communication of the Fed has to be scrutinized. The Fed has been hinting about reducing the scale of its purchases since the minutes of its FOMC minutes of May's meeting were released early April. This was further talked up by Chairman Bernanke during his Congress testimony in May and culminated in him actually giving an indicative calendar in the last week of this month. It is interesting to investigate what future policy might be by analyzing comments by Mr. Dudley, close ally of Chairman Bernanke at an event of committee on global financial system (lessons at the zero bound – the Japanese and US experience). The key take away is that monetary authorities would like

- the dosage of asset purchases to be dependent on future expectations of unemployment;
- guidance on short term interest rates to be linked with the inflation target
- monetary policy to take account of risks to financial stability

After Mr. Bernanke's remarks however there has been interventions of many Fed governors, most notably that of Mr. Dudley, close ally of the Chairman who clarified a couple of days after that a reduction of asset purchases was more linked to economic data rather than a calendar. An analysis of comments by Mr. Dudley at an event of committee on global financial system (lessons at the zero bound – the Japanese and US experience) provides more guidance on what future policy is likely to be.

This policy shift affects the investment climate as follows:

1. The 'mistakes' of QE1 and QE2 to which Mr. Dudley alleged in his speech is that they had a pre-determined size and duration which left a void after their lapse and affected expectations. However market participants and in particular hedge funds have built their investment strategy on these parameters through the use of carry trades by using the USD. We are now witnessing an unwinding of this strategy.

2. Notwithstanding risks to financial stability, the dosage of QE3 will be linked to unemployment. Thus it is only when growth returns to normal levels that asset purchases will be tapered.

The implications for investors are therefore to review their strategic allocation to mitigate short term volatility and obtain exposure to long term growth.