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GaveKal Five Corners

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Past Clashes in EU-US Monetary Policy

As Shakespeare said, "when sorrows come, they come not single spies, but in battalions". Just as the world economy has finally recovered from the 2008 disaster, financial markets are suddenly confronted with three potentially catastrophic and unpredictable risks. The two horrors understandably dominating the headlines are the earthquake in Japan and Libya's descent into civil war. Both these events, in addition to their human toll, threaten serious damage to the world economy by pushing oil prices even higher—a danger discussed at length in our recently published *Quarterly* and examined further by Charles on page 3. But a third risk, potentially just as serious for financial markets, has received much less attention. **This is the impending monetary conflict between Europe and the US.** On March 3 Jean-Claude Trichet shocked the markets by warning that the ECB would probably try to counteract oil and commodity inflation by raising interest rates at its next council meeting, on April 7. Two days earlier, Ben Bernanke had conveyed the opposite message to Congress. In his view, the oil shock would *"lead to, at most, a temporary and relatively modest increase in consumer price inflation."* Instead, Bernanke stressed that the oil shock, if sustained, could reduce real incomes and act as a new obstacle to economic growth. He offered no prospect at all of a monetary tightening, or even of curtailing quantitative easing before its planned completion in June. *"Until we see a sustained period of job creation, we cannot consider the recovery to be truly established,"* was how Bernanke summarised the outlook for Fed policy in the months ahead.

Since an oil shock is simultaneously inflationary and contractionary, economists can argue until the cows come home about whether Bernanke or Trichet is right. But for investors the disagreement between the Fed and the ECB raises a more urgent issue. History shows that policy disagreements of this kind between the Fed and the ECB, or the Bundesbank before it, have often been the harbingers of financial crises. We can identify four major monetary clashes between the US and Germany or Europe since 1970 and each has been followed by a financial accident of historic proportions.

1. In 1970, as the US sank into a mild recession, the Fed slashed interest rates from 9% to 3.5%. The Bundesbank, more worried about inflation, refused to ease substantially until nine months after the Fed and then started reversing its rate cuts in June 1971. Two months later, in August 1971, Nixon abandoned the gold standard and the Bretton Woods currency system collapsed.
2. On October 1, 1987, the Bundesbank unexpectedly orchestrated an increase of +50 basis points in market rates, thereby breaching the "Louvre agreement" to support the Dollar, at least in the eyes of the Reagan administration. A public attack on German monetary policy by James Baker, the US Treasury Secretary, was followed immediately by "Black Monday", the biggest-ever global stock market crash.
3. In 1991-92, while the Fed was pulling the US economy out of the 1990-91 recession, Buba again went on the war-path, following a row with the German government over the costs of re-unification. In July 1992, Buba raised its discount rate unexpectedly from 8% to 8.75%. Black Wednesday—the collapse of Sterling, the Lira and SKR—followed on September 16, 1992.
4. The latest such incident occurred in July, 2008, when the ECB raised its repo rate in response to the last oil shock, while the Fed was easing to relieve the banking crisis. Lehman went bankrupt two months later, although the causal connection was less obvious than in cases (1) to (3).

But is it really plausible that small changes in interest rates of 25bp to 75bp could trigger such massive repercussions? The next page considers why this might occur.

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Why Diverging EU-US Rates Policy is Dangerous

The impact of diverging US-EU rates is greatly increased if investors believe that the Dollar is in danger of a free-fall.

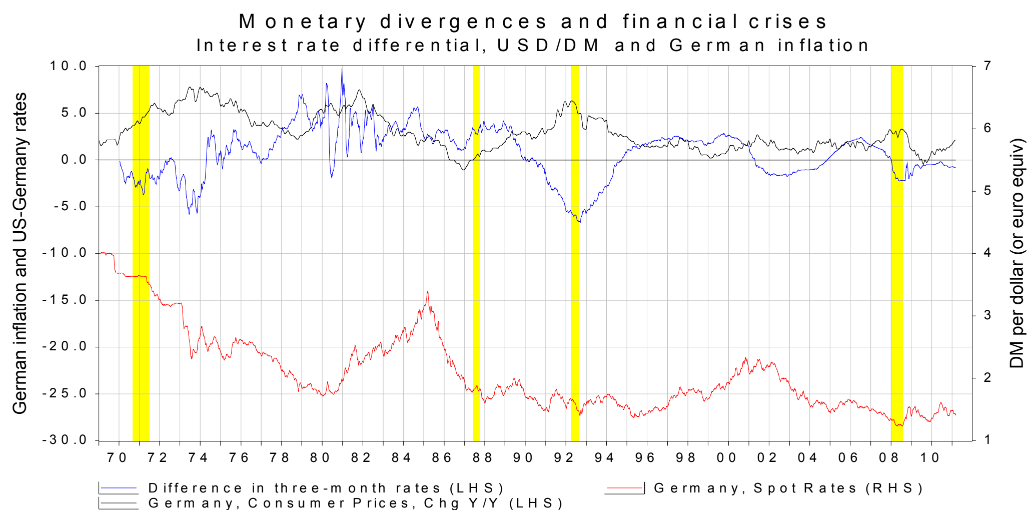
There have been plenty of occasions in the past when US and European monetary policy has differed enormously without causing any trouble, so how could the small divergences of monetary policy described on the previous page have had such enormous financial impact? There seem to have been two broad reasons—US currency weakness and German inflation. As shown in the chart below, each of the financial shocks identified (yellow shading) coincided with a new all-time low for the Dollar (red line) *and* a period of high or escalating German inflation (black line). Intuitively this makes sense. While a small shift in the interest-rate differential in favour of Europe (blue line) would not normally matter, the impact is greatly increased if investors believe that the Dollar is in danger of a free-fall or that a European rate hike marks the start of a major anti-inflationary campaign by the Bundesbank or the ECB. If the hawkish behaviour in Frankfurt appears to be unmatched by a similar anti-inflationary zeal in Washington, then the weakness of the Dollar is likely to exacerbated and the valuation of all financial assets, starting with US bonds and equities, is thrown into doubt.

These observations can be understood more generally in terms of the Dollar's status as the global reserve currency. While the Dollar remains the world's dominant reserve currency, its role and stability has constantly been questioned and tested by market forces since the late 1960s. The period since the breakup of the Bretton Woods system in 1971, therefore, has been one of reserve currency competition, first between the Dollar and the DM and now between the Dollar and Euro. All historical experience suggests that a world with standards of value (for example the Dollar and Pound in the 1930s, or the Pound and French Franc in the 18th century, or the gold and silver dollars in early 19th century America) is more unstable than a system with only one currency. All the more so if the two competing currency issuers have diverging monetary policies or different attitudes to the value of money.

Unfortunately, the conditions that have previously turned minor monetary divergences into major financial crises seem to exist in the world today.

Unfortunately, the conditions that have previously turned minor monetary divergences into major financial crises seem to exist in the world today. Worries about US currency debasement are widespread and the Dollar is only 2.3% above an all-time low on the Fed's trade-weighted index. Meanwhile, German inflation is accelerating and the ECB's attitude to the inflation-unemployment trade-off is diametrically opposed to the Fed's. Some people may agree with the Fed and others with the ECB in their views about this trade-off, but the two central banks cannot both be right. One or other must therefore be heading for a serious policy error. It hardly matters whether the Fed or the ECB is the one that blunders—either way, the financial consequences could be dire. What makes the present situation even more alarming is that a new transmission mechanism now exists for turning monetary blunders into financial crises: the risk of a banking panic or sovereign default in the Eurozone. However fears of such a crisis could yet deter the ECB from tightening—and by the summer, the Fed could well be ready to move in tandem with the ECB.

Both central banks cannot be right—either the Fed or the ECB is therefore heading for a serious policy error.



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Oil as a Threat to Economic Activity

As our readers know, we have, for some time, been pretty sanguine on the level of economic activity in the world. However, oil prices have rallied now close to +25% so far this year, throwing a serious wrench in the wheels of the global recovery. And while the turmoil in the Middle East seems to be abating somewhat, last Friday's disaster in Japan is very likely to add upside pressures on energy prices (see *The Latest, and Most Devastating Supply Shock*).

Let's try to summarize what we know today about the energy markets and the impact that any further disruption could have on the oil price and on the world economy:

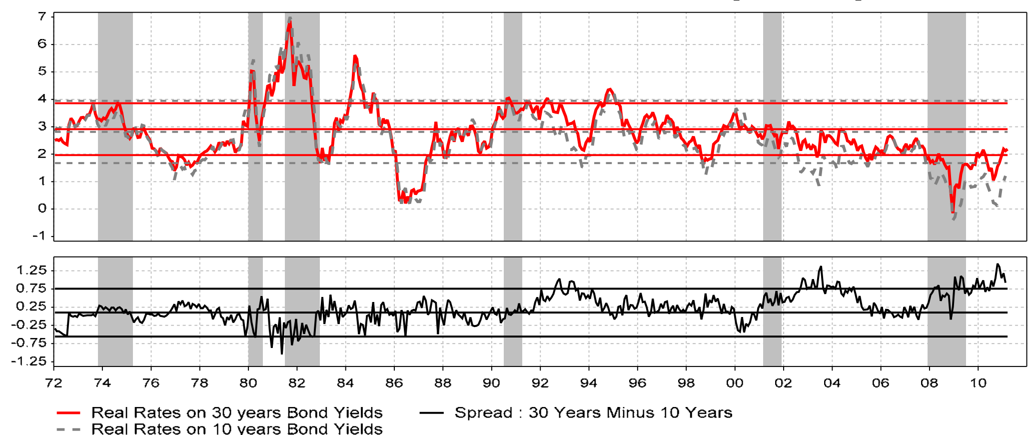
High oil prices destroy demand for the black stuff—however 'demand destruction' is just a fancy word for a recession.

1. The supply and demand situation is finely balanced, to the point that any further disruption (above 1.5mn bbl/day) in the production of oil would lead the market to be in short supply.
2. If we move to a serious supply shortage, there is little doubt that the price of oil would jump brutally, taking the price of a barrel well above US$130/bbl.
3. Most studies we have read on the subject put US$130/bbl as the breaking point where demand destruction starts to happen (see page 19 in our latest *Quarterly Strategy Chart Book*). Of course, demand destruction is just another fancy word for a recession.
4. So we stand in front an almost binary scenario: either 1) oil prices do not manage to break US$130/bbl and start trending down, in which case we want to increase risk; or 2) oil prices climb beyond US$130/bbl, in which case we want to de-risk aggressively.

With such a decision tree, it would not be reasonable to leave portfolios unhedged against rising oil prices. But today, the problem is that most of the conventional hedges are quite expensive. However, perhaps there is a cheaper way?

At this point, hedging against a recession might be cheaper than a straight-out oil hedge.

As we all know, the Fed has been busy manipulating short and long rates for the best part of the last ten years, despite having very little to show for it (see *The High Cost of Free Money*). Today, the Fed's QE programs are concentrated on durations between two and ten years, which means that the 30-year bond market is, comparatively, left to its own devices. As a result a huge spread in the valuation between the 10-year and the 30-year has opened up. As the chart below highlights, the 10-year is more than one sigma overvalued, while the 30-year is in its normal valuation range—to the point that now the 30-year is offering an extra yield of 100 basis points above the 10-year. But what does this have to do with hedging for against rising oil prices? If oil continues to spike, a recession becomes inevitable and the 30-year, moving from a "normal" level, should outperform the 10-year, which starts from an overvalued level. On the flipside, if oil does not go up, then the 10-year will decline a lot more than the 30-year. One could also increase the hedge if oil goes up, reduce it if it does not…



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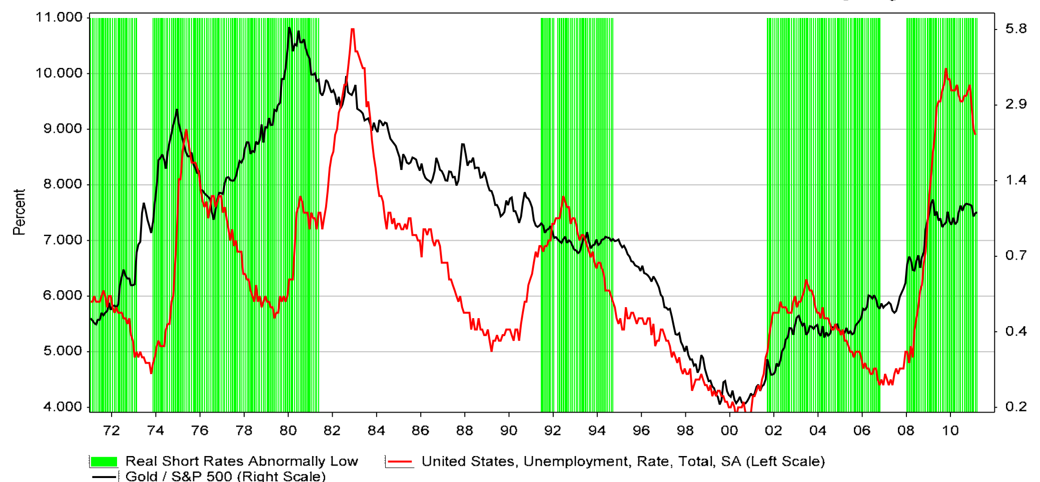
False Prices, Unemployment & Asset Duration

One of the most important prices in an economic system is the price of money. If the price of money is manipulated by a central bank, then money is no longer at a market price (see the works of Jacques Rueff). Furthermore, if we assume that any economic system typically has two kinds of assets, 1) those with zero duration (e.g., gold and silver), and 2) those with long durations (e.g., the S&P 500), then a non-market, or false price of money will distort the relative values of the zero- vs. the long-duration assets. After all, an ounce of gold remains an ounce of gold, regardless of whatever interest rates are. **But how does one compute the present value of a share if one has no confidence in the risk-free rate in the earnings discount model?**

When the earnings discount rate cannot be trusted, investors shift to zero-duration assets, like gold and silver.

This uncertainty means that, when negative real short rates are maintained over a long period of time, investors will gravitate towards the zero duration assets. In turn, this amounts to a massive misallocation of capital, since zero duration assets have no return and create no growth. Ultimately, if the gold market absorbs a large proportion of investment flows, then unemployment will have to rise:

Relative Performance of Gold vs S&P500 & US Unemployment



Source: Reuters EcoWin

This in turn causes unemployment—which is why the Fed's current argument against normalization is bunk.

In *The High Cost of Free Money*, we tried to show how destructive negative real rates are—especially for those looking for employment. This is where the ultimate paradox lies, since the low cost of money is almost always justified by the desire to create jobs. As Saint Paul said: "*I don't understand what I am doing. For I don't practice what I want to do, but instead do what I hate.*"

Since 2002, and for the best part of the last 10 years, the Fed has been operating under the misguided impression that low rates help growth and employment. Nothing is further for the truth. **What creates employment is economic growth, which cannot happen if capital is allocated to non-growth assets.** Moreover, the process of creative destruction, also crucial to growth, cannot take place if real rates are negative; ergo negative real rates in a mature economy always lead to a rise in unemployment.

Today, zero duration assets are probably just as overvalued vs. the long duration assets as they were in 1979. In 1980, when real rates swung back to positive, gold went from \$800/oz to \$200/oz in just five years. At the same time, oil fell from \$40/bbl to \$10/bbl, Latin America went bankrupt, modern art prices collapsed and the S&P 500 tripled. The same thing could and should happen now, if only real short rates became positive again.

In Europe, the ECB and the Bank of England have started to move in the right direction, albeit ever so slowly. But in the US, the Fed still insists that normalization cannot take place until unemployment improves. Volcker, where are you when we need you?

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By Charles Gave

Böhm Bawerk, Commodities and Monetary Policy

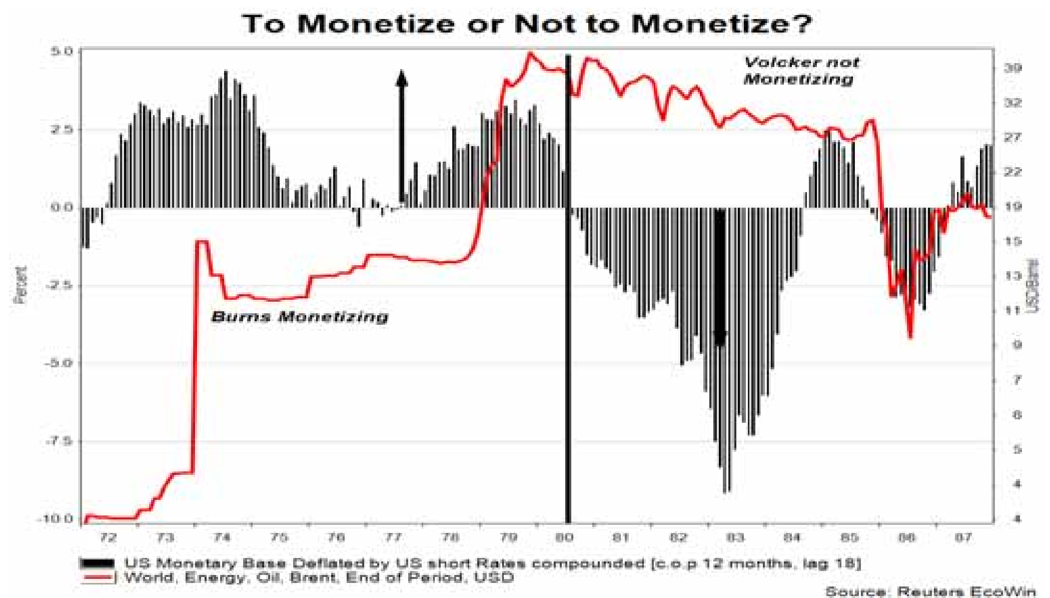
If the price of one commodity spikes, then an economy will have less money with which to buy other commodities.

Böhm Bawerk taught economics to both von Mises and Schumpeter, which should be enough for any reader to understand how great this man was. Among his many brilliant ideas, was his view that if one commodity price experienced a huge and abrupt rise, then other commodity prices would have to go down, since there is a limited amount of money which can be spent on commodities at any given point.

This makes plenty of sense if one is operating under the gold standard (which Böhm Bawerk strongly supported), since base money in such a system cannot increase beyond the inventory of gold owned by the central bank. But since we have now moved to a global fiat currency system, where the quantity of money can and does increase, do Böhm Bawerk's ideas still hold? Fortunately, to help us answer this, we have two distinct historical examples:

- **The first oil shock of 1973**. Oil was traded almost exclusively in the US Dollar and the Fed chairman at the time, Mr. Burns, decided to monetize the rise of oil prices to break the "Böhm Bawerk constraint." Of course, this led to untold disasters: runaway inflation, collapsing stock markets, the rising power of the OPEC cartel, the seeds sown for the clerics to take over in Iran, etc.
- **The second oil shock of 1979**. The new chairman of the Fed, Volcker, decided that under no circumstances would he accept a monetization of the oil price increase. This decision almost immediately created a huge Dollar shortage, with real rates going through the roof, together with the Dollar exchange rate. Among other things, this means that anybody who had borrowed in Dollars went bankrupt (Mexico, 1982). And while the immediate pain was intense, this decision paved the way for 20 years of economic growth, falling inflation and rising asset prices.

Does this economic theory work in a world in which the central bank can print money?



Today, we are once again facing the same dilemma. Since QE2, the Fed has been busy monetizing oil price increases, to the point that the environment is starting to get eerily reminiscent of the 1970s, including a brewing revolution in the Gulf area. If the Fed decides to continue to monetize, then it will be very difficult to remain constructive on financial markets. **One cannot operate a capitalist system with the leading central bank intent on destroying market prices** (see previous page). After all, market prices are the signals that allow entrepreneurs and consumers to allocate their resources efficiently. To be blunt: this type of system has been tried before—it was called the Soviet Union and it did not work.

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by Conor Colwell

The New Threat in Media Markets

In 1948, the US Supreme Court found major film studios in violation of the Sherman Anti-Trust Act. Their control of the production studios (content) as well as the theaters (distribution) allowed studios to force many venues to screen only "approved" films. The Supreme Court upheld the US government's ruling that this vertically integrated business model limited progress and competition within the sector.

We could see more M&A between entertainment distributors and the content providers.

Yet in many ways, restrictive barriers to distribution have re-emerged in the decades since the 1948 ruling—this anyway is what the pushback against the emergence of internet-based TV options (Netflix, iTunes, Google and Amazon) would indicate. The internet distributors are offering significantly cheaper models that allow for targeted purchases of content—instead of purchases of packages of content—and in the process are disrupting the cushy and entwined relationships that define current content distribution systems. As a result, the cable companies and TV studios are looking for ways to fight against the new threat. **And with the recent FCC sign-off on the merger of Comcast and NBC Universal, we may have seen the first in a series of similar strategic pairings between cable/telco distributors and entertainment companies.**

Both sectors have reasons to fear the Internet challengers:

- **Distributors** (cable companies) lost subscribers for the first time ever in 2Q10—a drop of -711,000 customers. Meanwhile, companies purveying cheaper a la carte options thrived: e.g., Netflix and Hulu visits were up +189% YoY and +68% YoY respectively. The irony is that these new, significantly cheaper alternatives can profitably undercut traditional pay-TV by delivering content through the web—the infrastructure also owned by the cable companies. Cable companies are attempting to block these services by raising usage fees and establishing bandwidth limitations. For instance, as a company that controls the 'last mile' of network delivery, Comcast recently attempted to enforce 'toll booth' like sanctions on Netflix's content delivery network provider. And though currently under appeal, Canada's dominant ISPs successfully lobbied the Canadian regulator to mandate bandwidth caps of 25gb per month per customer on Internet plans—potentially quashing the competitiveness of companies like Netflix.

In our view, too many consumers already prefer online content distribution models—incumbents cannot block this phenomenon but must adapt.

- **Content owners** also appear threatened by the industry disruptions brought about by the online distributors. NBC originally blocked content from Apple's iTunes as they felt the price tag of $0.99/episode "devalued" their material. ABC, CBS, and NBC have blocked the content from their respective websites from being played on Google TV—they do this because GTV places the shows available on pay-TV next to free or very cheap fare, a side-by-side comparison which the studios clearly do not like. As for Hulu, many feel this model builds customer entitlement to cheap content, factors reminiscent of the record labels' early demise. Yet content owners are in a better position to adjust to new models—indeed, they are already testing the waters. Hulu, for example, is owned by a number of studios and claims an average ad revenue of US$0.14/per viewing of a half hour episode (see *here*). This ad monetization has increased over the last three years at a CAGR of +81%, surpassing standard cable at an estimated US$0.11 per half hour episode—and is poised to surpass traditional broadcast's US$0.22 within the next year.

Because distributors have the most to lose from Internet-based competition, we expect they will lead any charges on the M&A front (as is the case with the Comcast/NBC merger). This is a positive for the share prices of content providers, but a challenge for the distributors. Especially since any such partnerships will only temporarily slow the progress of online syndication—in our view, the industry has passed a tipping point.

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