SEMI-MONTHLY FISCAL/MONETARY UPDATE - CENTRAL BANKS BUY STOCKS AND BONDS - A LONG TERM DISASTER !!

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A LESSON IN “MAKING MARKETS”

It’s been a number of years since we had an active market for initial public offerings. Decades, and a number of stock market cycles ago, this then young analyst watched quite a few small companies come public, in many cases underwritten by brokers much smaller than the surviving investment bankers of today. Some of those underwriting firms, well intentioned to be sure, supported the brand new issue with a supporting bid, figuring it was just a question of time before the market figured out that the stock was attractive, the supporting bid could be removed, the stock would be freely trading and move up, the public customers would be happy, and the broker might even make a profit when selling their acquired inventory. Other underwriters, not so committed to supporting the new issue price, allowed the stock to trade freely immediately, tolerating the higher volatility, and allowing the free market to establish (“discover”) the price, for better or worse.

The interesting aspect of these two approaches was as follows: The firms that intervened in the marketplace in many cases finally choked on the inventory, their capital was not sufficient to buy the stock forever, and they ultimately went out of business. The more prudent underwriters that allowed for “price discovery” (as the PHDs would put it) by the normal supply and demand of the marketplace lived to play another day.

This small scale example applies to the trading habits of worldwide central banks today. As the US government builds its debt over $22 trillion, which is more than 100% of our GDP, lots of observers say it is no big deal since Japan, for example, has government debt at 250% of their GDP. The Japanese economy is still functioning, with slow growth to be sure, but there is no evident crisis. This reminds me of the cartoon where the guy jumps off the cliff, and, while in the air, calls out: “I feel fine !!”

There are over $10 trillion of government securities trading with less than a zero percent yield. This is as a result of the US, ECB, Japanese and Chinese central banks buying stocks and bonds, supporting the price of stocks and bonds, and suppressing fixed income yields. In this absence of true price discovery by the marketplace, fixed income savers have been penalized, to the benefit of stock and bond holders, creating a wealth effect for the latter. This good fortune on paper could (and will) be temporary, but for the moment, just like the guy who jumped off the cliff, we feel fine !!

Where are we in this process ?? In addition to the negatively yielding fixed income government securities, the Bank of Japan (that has been doing this for almost thirty years) now owns about $250 billion of Japanese ETFs, or *75% of that entire marke*t of ETFs. On the fixed income side, the Bank of Japan owns *about 45%, or $4.5 trillion worth of all the Japanese government bonds outstanding.* With it all, the Japanese economy is still running well below 2% real growth, with inflation at well under the 2% objective. It is of course an important sub-text that central banks worldwide are trying to stimulate inflation, rather than subdue it, which was the original objective. Closer to home, we have been informed that our Fed is abandoning QT, preparing for a new form of QE, which, some have suggested, could include the purchase of US equities as well as bonds.

Here's a quick economic lesson for the hundreds of PHDs that are working within central banks, which we guess isn't part of the new Modern Monetary Theory. ***Don't intervene in a market unless you are prepared to BUY IT ALL, because you will, eventually.*** Witness the holdings of the Bank of Japan, who have been at this game the longest, still without the result they have been reaching for. Aside from a long list of unintended consequences that have yet to play out, the attempt to lighten the inventory, (Sell to whom?) has just been demonstrated in the US. One down month in the stock market (December) with the two year treasury rate approaching 3% and the US Fed caved. Whom do you think the Japanese Central Bank can sell to?

The above described central bank intervention in capital markets will inevitably destroy most international currencies, including the US Dollar, because the money will have to be created to support the capital markets and the presumed wealth effect that will prevent economic collapse and that will be highly inflationary. This is the "bubble" that Donald Trump described when he was campaigning but that he has forgotten about since he is in office. The politicians and central bankers will continue to chase their long term (NEW) goal of creating inflation substantial enough to service long term debt obligations. The debt, worldwide, is far too large to be paid off in the currencies of today. Substantial inflation is the only politically acceptable remedy, since outright default is too obvious to the voting public.

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