Newsletter No.32

June 2013 Alvine Capital Newsletter

Following the Fed punchbowl or taper?

Key issue: following the money **is following the Fed** given the vast power and global influence at play.

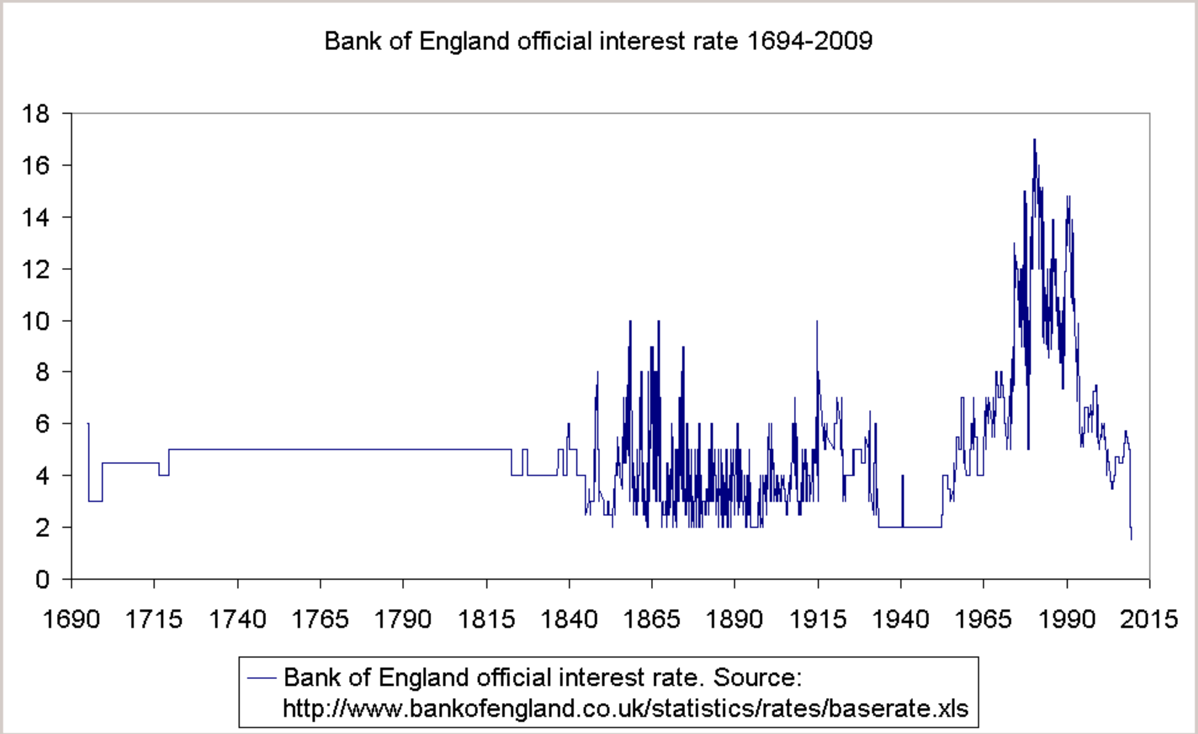
Key recommendation: Chairman Bernanke in perhaps his early valedictory tour has signalled a likely change in direction. Our focus must now be on his successor to ascertain if this new policy will prevail.

'I take the punch bowl away just when the party is getting good' William McChesney Martin Chairman of the Federal Reserve 1951-70.

A famous teetotaler, McChesney was not afraid to use the Fed's powers over monetary policy during his nineteen year rule. In understanding what move markets, and ultimately the economy since the birth of modern central banking, this creates **'Fed watching'** as the most important game in town.

A long era of passive monetary policy

At a hundred, the Federal Reserve System may be only an infant compared to the venerable Bank of England that was formed in 1694. During much of the first couple of hundred the years, a concept of actively managing the monetary affairs of the nation would have been considered anathema. Economic and business cycles would come and go, attended by financial crises and the inevitable crashes.



'The Bank was amazingly detached from international affairs: heard from no one; saw no one, only watched the gold and took the necessary steps automatically.', Sir Ernest Harvey Chief Cashier (Source: History of the BOE).

However as financial markets became larger, and hence more likely to affect the real economy, pressure from politicians led to the creation of the Fed and for others like the BOE to adopt an activist monetary policy.

A history of Fed activism

In the aftermath of the first world-war, America's status changed from lead debtor to creditor. The damage that had been done to the old world economies of Europe irreversibly changed the nature of international finance.

As Chairman Benjamin Strong assumed the mantle of leadership for the world's monetary policy, and for the first time conducted an activist policy. The dry passive world of gold flows was replaced with attempts to manage, sterilise or otherwise influence the flows of money.

Benjamin Strong—assuming control of the economy

"Never forget that [the Federal Reserve] was created to serve the employer and the working man, the producer and the consumer, the importer and the exporter, the creditor and the debtor; all in the interest of the country as a whole." ("A reminder written by Benjamin Strong and always kept in the top drawer of his desk", page 1, source: Biographer Lester Chandler 1958).

The **great depression** represented the first real challenge to this new approach. Initially with little action, but subsequently with **FDR's activism** government influence with the central bank at the forefront, became to be seen as decisive in overriding laissez-faire economics. In fact it was often argued that the early death of Strong in 1928, temporarily robbed the US economy of precisely the activist skill set needed to confront the looming disaster. It was only after the election of Roosevelt, and his hyper activity that recovery commenced.

"Behind government currency we have, in addition to the promise to pay, a reserve of gold and a small reserve of silver, neither of them anything like the total amount of the currency.", FDR Fireside chat 7/5/33 (Source: www.moonlightmint.com).

The government in making it illegal for private citizens to hold gold, helped to partially monetize the currency.

Stop-go the post war era

Our leading 'punchbowl' quote gives the best clue as to how monetary policy was applied, as growth picked up and inflation with it the brakes were put on the economy by **raising interests** through the funds rate. And when economic conditions then slowed, stimulus could be resumed with **rate cuts**. This was the apogee of believing that demand, and hence the economy could be managed.

The 1970's inflation and Volcker

Partly due to the external shocks of the commodity boom and oil shock inflation became far more entrenched in the US than for a generation. The then Fed Chairman Arthur Burns was slow to recognise how lax monetary policy had become. It was only when Paul Volcker assumed office at the end of the decade that an aggressive tight monetary policy was deployed. Inflation was tamed, but at the expense of a short, sharp bear market for all financial assets.

The Greenspan put

Almost from the moment Alan Greenspan assumed the Chairmanship crises seemed to multiply. From the October 1987 stock market crash, to the Tequila Mexican crisis, to Asian meltdowns or the Russian government default in 1998. But at all times the Fed seemed to ***want to understand*** how these events could act as seismic to the very fabric of the international financial system. Accordingly, **aggressive easing would prevail** to bail things out. Calm, and ever rising asset prices would ensue.

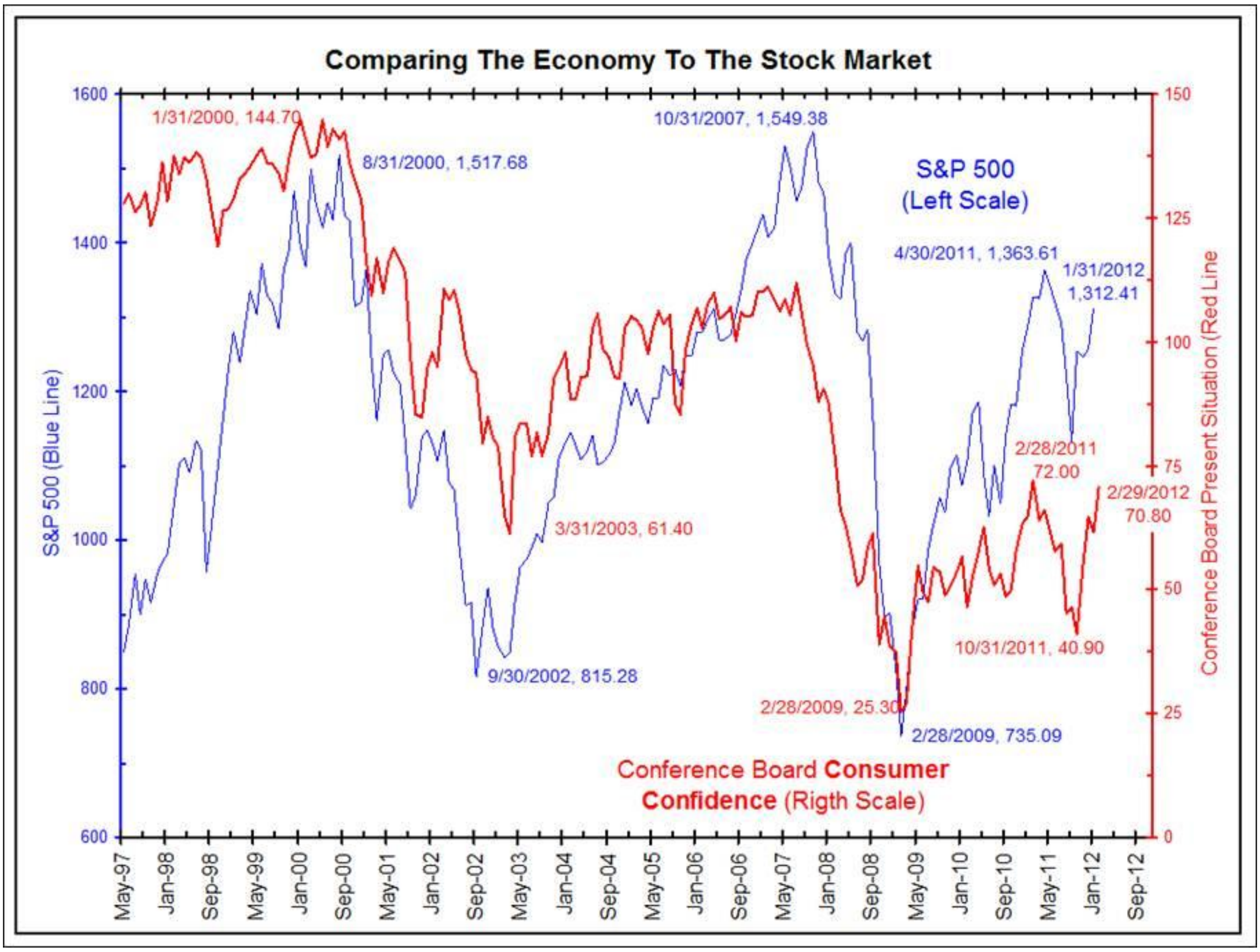
Helicopter Ben

Professor Ben Bernanke of Princeton University had made much of his reputation before joining government service as a student of financial history, and in particular the great depression. Accordingly his analysis that if enough had been done by the central bank to alleviate liquidity shortages much of the damage might have been avoided, even by means of delivering cash by air from a helicopter.

This skill set has certainly been put to the test during the extremes of the financial crisis. What had been largely dry academic speculation was rapidly a real time crisis. Washington and the Fed faced the onslaught of the crisis. Bernanke did not flinch instituting firstly swift cuts in the funds rate, and then following this up with the first rounds of QE. Furthermore he added his weight behind moves to rescue key parts of the financial system such as Bank of America and AIG.

'No doubt about it Ben Bernanke saved the **world from a depression',** David Blanchflower former BOE monetary policy member (Source: New Statesman 12/5/11).

Portfolio channel balance: the Fed and asset prices



Federal Reserve---boosting confidence in the economy by bolstering the stock market

The first rounds of QE were necessary, emergency actions to restore confidence into a shattered system. But follow ups have been more controversial. Many economists and commentators have struggled to see how asset purchases, in particular of government securities, could help the 'real' economy.

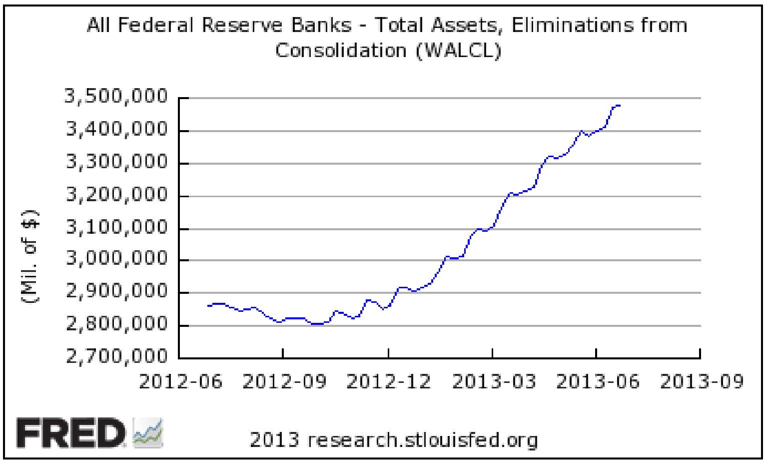
The Chairman in his many trips to Capitol Hill has sought to explain. Introducing the concept of 'portfolio channel balance', Bernanke explained that the effect of higher asset prices was exactly what the Fed could deliver. This is turn would bolster confidence, make it easier for companies to finance themselves, hence leading to investment in the economy. Higher stock prices also gave a boost to the investor wealth effect, helping to enhance consumption.

It might be a blunt instrument, but it was all that could be done.

‘So the premise is: Buy a bunch of long-term bonds and mortgage backed securities, and hope that that pushes money into areas like corporate bonds, thus making it cheaper for corporations to borrow‘, Joe Weisenthal (Source: Business insider 9/9/12).

Read more: http://www.businessinsider.com/bernanke-how-quantitative-easing-works-portfolio-balance-channel-2012-9#ixzz2XQyZwY9r

The end in sight QET(aper)?



This is hardly a new chart, and we have all seen the inexorable rise in the Fed’s balance sheet. So we should hardly be surprised that throughout the QE program a great deal of pressure has been exerted on the organs of the state as its efficacy. From eminent economists, to truculent Republicans, asset purchases have been controversial. But the FOMC had judged that was part of the dual mandate, they were obliged to use the Fed’s tool kit.

In November 2012 instigation of seeming QE infinity, with simple easy to understand caveats as to when the program would be halted the Evans rules, Fed policy appeared set.

Asset purchases at $85bn per month would continue until what seemed quite remote, and hard to achieve targets namely an inflation rate exceeding 2.5%, and unemployment of below 6.5% Bearing in mind the Greenspan years, and the apparent historical preponderance of easy money most commentators (ourselves included) sat back and assumed the punchbowl moment was a long way away.

Ben Bernanke: the long goodbye

The Fed Chairman's initial comments given on the hill in mid-may about possible scaling back QE surprised the market, some commentators went as far to say they were a gaffe. However despite a fairly muted statement after the June FOMC meeting, in the subsequent press conference the intent to flag a possible change in policy was clear.

In the subtleties of 'Fed speak' there now exists flexibility, and bias to remove asset purchases. Needless to say plenty of caveats exist about the future pace of activity and how that will affect timing, but the presumption of a 'low bar' to policy change is gone.

Since the news conference there has been a veritable eruption of commentary by other members of the FOMC, both voting and non-voting. This suggests, to say the least, the committee is no longer fully behind the chairman. A reasonable question must arise as to why Bernanke has risked such open dissent?

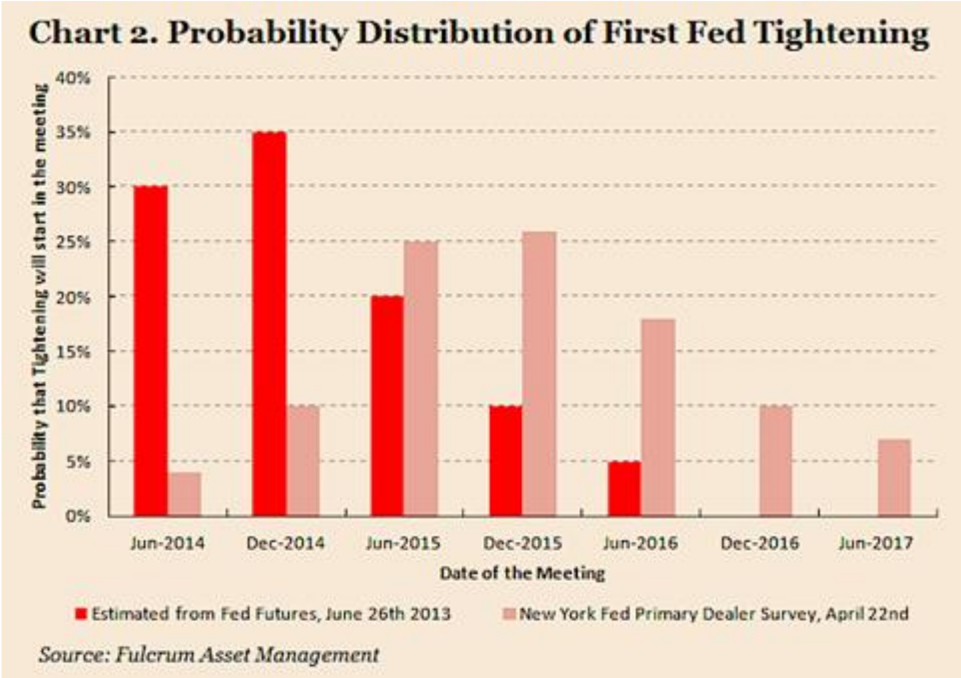
Unlike his predecessor Alan Greenspan, Bernanke has never seemed to bestride the world of media and 24hr news. While he has managed the public sessions of his job, a certain lack of enthusiasm is difficult to avoid. So the debate about a possible 3rd term has turned very much against its probability. The President hinted as much: **'he's already stayed a lot longer than he wanted or was supposed to.',** (Source: FT.com 18/6/13).

With the exit barely six months away it would only be natural for Bernanke to be thinking about his legacy. **To be remembered as 'helicopter Ben' or the man who bravely signaled the likely end of monetary printing?** Whatever the motives as we start to say goodbye, and Bernanke returns to Princeton, fresh analysis of his replacement will concentrate minds.

Conclusion: Fed policy in a state of flux

In the space of a few days the state of the FOMC committee's dissent has been laid clear, Bullard going as far as to issue his own FOMC 'statement' on the St Louis's website. While San Francisco's John Williams (claiming tapering was a long way off) clashed with Dallas' Richard Fisher (it is very much on the agenda).

We expect this debate to continue as the Chairman's authority drains away, and focus to who his successor may be. Whichever way this is resolved, volatility is likely to be enhanced and genuine fears as to how financial markets could cope with or without massive central bank support.



We will focus later in the year on the vital decision as to who will be the new Chairman of the Federal Reserve.

Model portfolio: reducing risk

With the S&P 500 already reaching our year-end target of 1650 an inevitable pause in prices has taken place. The fact that this has coincided with serious questions about Fed policy must determine a more cautious approach.

Accordingly we will continue our reduction in equity exposure commenced at the end of April, and bring our portfolio back to a neutral stance. We await central bank developments and market setbacks towards the end of the year.

July Newsletter: in search of un-correlated assets

This material is confidential and is intended solely for the use of the person or persons to whom it is given or sent and may not be reproduced, copied or given, in whole or in part, to any other person. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be solely relied on in making an investment or other decision.

The information and opinions presented here are for background purposes only and do not purport to be full or complete. No reliance may be placed for any purpose on the information or opinions contained in this document or their accuracy or completeness. No representation, warranty or undertaking, express or implied, is given by Alvine Capital as to the accuracy or completeness of the information or opinions contained here and no liability is accepted by Alvine Capital for the accuracy or completeness of any such information or opinions.

No information provided herein shall constitute, or be construed as, an offer to sell or a solicitation of an offer to acquire any security, investment product or service, nor shall any such security, product or service be offered or sold in any jurisdiction where such offer or solicitation is prohibited by law or regulation.

UK Residents: Alvine Capital Management Limited is regulated in the conduct of investment business by the Financial Conduct Authority, ("FCA").