March 2012 Alvine Capital Newsletter

# Why the personality and character of modern central bankers are now so pre-eminent in understanding markets

**Key issues:** monetary policy has become far more activist, and now can surpass the influence on markets of traditional levers such as earnings or economic data.

**Key recommendations:** we all need to redouble our efforts as Fed/ECB/BoE/BoJ watchers. With their vast monetary firepower they are now the decisive movers of markets and business cycles.

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**'Central bankers are now like rock stars, selling books about their time on boards of governors and testifying in front of legislative bodies'** (Money and Banking: An international text by Robert Eyler.)

Economists, market strategists and investors used to concentrate their analysis on a variety of indicators to ascertain general movements in asset prices. The fashion of various moments might have been M3, trade balances, consumer confidence or corporate earnings. During the financial crisis that began in 2008 greater emphasis now needs to be given to the extremes of monetary policy decision making. The uniform, almost co-ordinated movement to near zero interest rates, has been concertinaed with vast increases in central bank balance sheets. It is this ***'beef'*** that now dominates market, and indeed economic activities. Accordingly, it is what's behind these decision makers and their processes, which must focus our attention.

## The Gold standard made monetary policy automatic

Most of monetary history has been characterised as non-activist**. The movement in the money supply was dictated solely by the influx, or redemptions of gold bullion**. Attendant changes in interest rates reflected needs to stem, or enhance these flows.

After the First World War as much of Europe lay in ruins, gold flows increasingly sought the perceived safe haven of the United States and its new Federal reserve system. As these amounts accumulated during the mini-slump of 1919/20 in Europe, the Americans were presented with a quandary. Under the traditional banking standards of the day, they should have allowed this 'money supply' to flow into the economy as gold was quite literally the base of the monetary system. However, the US economy had, if anything, benefitted from the war time years, and was already beginning the roaring twenties. Should the Federal Reserve passively sit by and allow this unintended boost in money supply to flow?


**Benjamin Strong** the first modern central banker

Strong was elected Governor of the New York Fed at the first board meeting ever held on October 5th 1914, still only 41. Having already enjoyed a successful career at, amongst others, Bankers Trust, he was to take a far more activist approach to monetary policy. This lead to the effective **sterilisation of the increased gold supply in the early 20's** so choking off some of the boom already flowing. It is for this reason we cite him as our first prominent Central Banker.

Milton Freidman was to explain this when he commented on how things might have been different with Strong in office during the early years of the depression (he had in fact died in office in 1928.)

**'If Strong had still been alive and head of the New York Bank in the fall of 1930, he would likely have recognized the oncoming liquidity crisis for what it was, would have been prepared by experience and conviction to take the strenuous and appropriate measures to head it off, and would have had the standing to carry the system with it' (A Monetary history of the United States p412/3.)**

**Anonymity—men in grey suits**

For much of the 20th century the world of central banking was populated by establishment figures that had little interest, or influence over monetary policy let alone a wider bearing on the economy.

The Bank of England Governor through the 1980's Robin Leigh-Pemberton was one such figure, an old Etonian with a more ceremonial role. It is true that attempts continued to try to manage the economic cycle by means of interest and fiscal policy, but at least in England this was the preserve of the politicians. With the exception of the Germany, Japan, Switzerland and the US, central bankers were concerned by statute with only the plumbing of the system and not with the broader economy.

**Inflation success—Volcker and the 'Buba' (Bundesbank) showed how**

Most of the western world had abdicated monetary matters to the politicians, not surprisingly this spawned a constant battle with inflation. In many emerging nations such as Brazil and Argentina, hyper-inflation was never far away.

However, when monetary policy had been delegated to a central bank, with a clear mandate for price stability, then the story was very different.

| Frequency | | Annual | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Time | | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
| Country | | | | | | | | | | | | | |
| France | i | 7.380597 | 13.64932 | 11.68593 | 9.625493 | 9.494556 | 9.250559 | 10.64674 | 13.56258 | 13.3144 | 11.97848 | 9.459548 | 7.673803 |
| Germany i | i | 7.032024 | 6.986428 | 5.910336 | 4.246631 | 3.734169 | 2.718691 | 4.043622 | 5.441055 | 6.344242 | 5.241046 | 3.293413 | 2.405797 |
| United Kingdom | i | (E) 9.196044 | (E) 16.04399 | (E) 24.20729 | (E) 16.55952 | (E) 15.84027 | (E) 8.263139 | (E) 13.42129 | (E) 17.96593 | (E) 11.87662 | (E) 8.59887 | (E) 4.609302 | (E) 4.960712 (E) |
| United States | i | 6.17776 | 11.0548 | 9.143147 | 5.744812 | 6.501684 | 7.630964 | 11.25447 | 13.5492 | 10.33471 | 6.131427 | 3.212435 | 4.300536 |

1970's Inflation higher in the UK and France without independent central banks (source OECD)

**Higher inflation countries did enjoy growth prospects, with this realisation came that 'sound money' would be an asset for any economy.** The path was clear for those countries that did not have independent central banks, and one by one the cult of an independent bank was established.

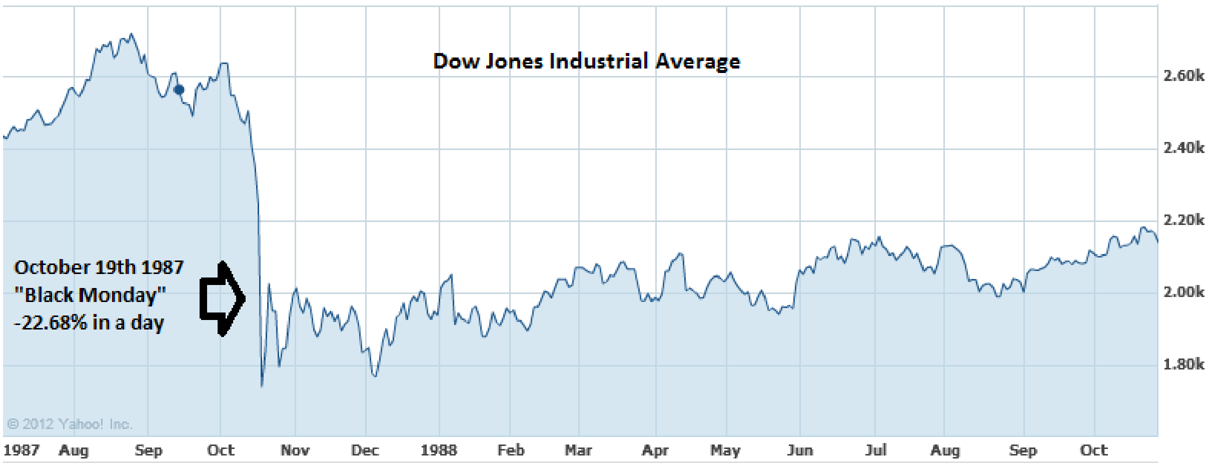
Central banking at its best produces a clear separation from the political process, and can act much like an independent judiciary. Short term desires by politicians to manage the electoral cycle are vitiated, with the tough decisions to rein back activity with higher interest rates taken with the objective of stable, low inflation.

As Chairman in the 1960's William McChesney Martin put the role of the Federal Reserve;

**'to take away the punch bowl just when the party gets going'** (source NY Times obituary 29/7/12.)

**Greenspan and the bull market**

Alan Greenspan took over from Paul Volcker at a propitious time in 1987, with the US economy and financial markets having boomed nicely over the previous five years. However, his skills were going to be tested sorely when on October 19th the stock market crashed, the single biggest one day fall in history even surpassing 1929.




1987 crash (source YahooFinance.com)

Would the US now fall into recession, or worse, in this crisis environment?

The new Chairman did not disappoint, and performed his vital role in shoring up any seismic risks to the system. After a few more weeks of turbulence, the markets and economy returned to normal with little lasting damage.

**A state of permanent crisis?**

Having been tested under fire in 1987, the next crisis was not far away. This time it was to be the US Savings and Loan industry followed fairly soon by the recession of 1991/2. Then we had the tequila Mexican blow up, the Asian currency crash of 1997, Russian debt default of 1998 and so we go on.


This is how Time magazine saw it -'the celebrity central banker was born. Not a wonkish, grey-faced committee with a mundane mandate, but the standard-bearers of the economy' (Axel Merk www.marketnightshift.com.)

It is easy to see these as isolated events, but the pattern was the same. The Federal Reserve, aided and abetted by other central banks, would bail out the system. **The 'Greenspan Put' was born.**

Giving 'a description of the perceived attempt of the then Chairman of the Federal reserve board, Alan Greenspan, of propping up the securities markets by lowering interest rates and thereby helping money flow into the market' (investopedia.com dictionary.)

Markets, investors, politicians and investors alike came to expect this sort of constant activism.

**24 rolling news and the birth of 'financial porn'**

The way that business, politics, or for that matter, central bank policy making is conducted is now in the spotlight of media attention. It may be that the various financial events/crises over the last twenty years are in fact not that dramatic (compared to for example Mexico's default in 1982), but they have been made to look that way by the pressures of the modern world.

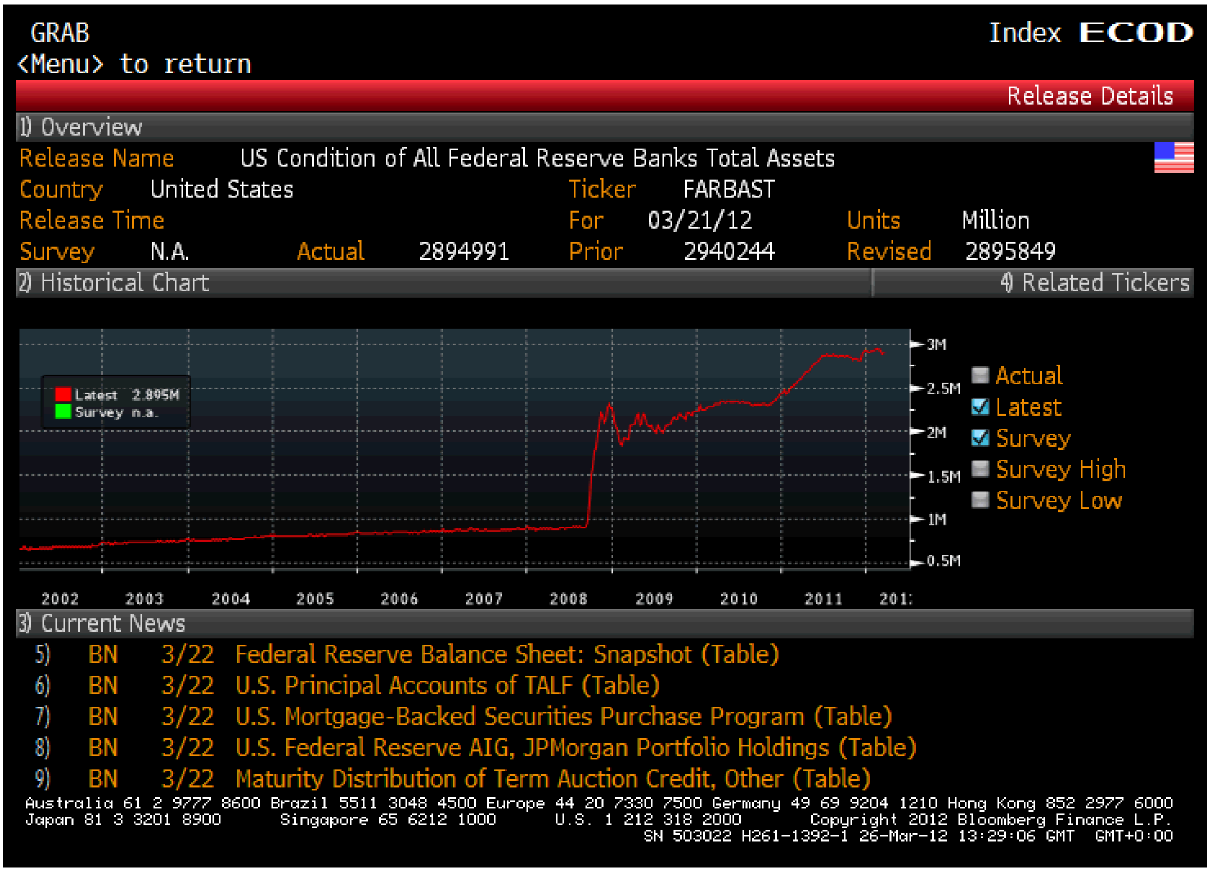
**'Financial TV is pornography-sleazy, intrusive, seeking to titillate, and shock. During a crisis, these programs can be compulsive'** (Extreme Money: Masters of the Universe and the Cult of Risk Satyajit Das.)

All our leaders have been forced to extend their participation in this space. Accordingly, the modern central banker has taken a prominent role in public life.

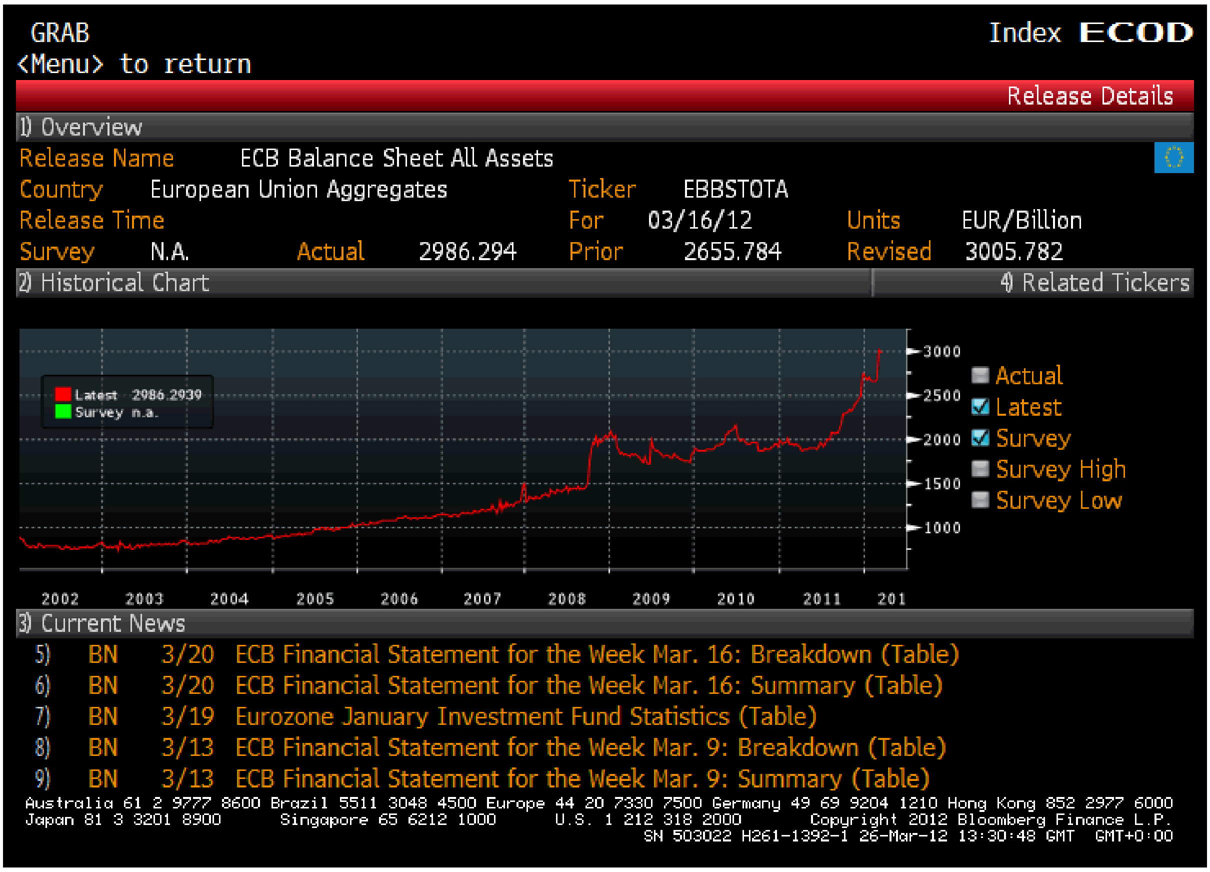
**The consequences of modern central banking- watch this space**

First it was Alan Greenspan who bestrode the world as a financial colossus, then it was Ben Bernanke his successor. While Melvyn King does not perhaps have the presence or panache of his American counterparts, the impact on policy has been as great. Our next knight of the markets is the newly appointed President of the ECB, ex-managing director of Goldman Sachs Mario Draghi.

All these players have, rightly or wrongly, proved to be arch interventionists. It is not our job for this article to speculate on the wisdom of this approach, but merely to point out how egregious it has been.




Fed balance sheet a lot of money! (Source Bloomberg)




ECB anything you can do.... (Source Bloomberg)

The overriding issue here is that these sums are just so large that they overwhelm other factors that might impact markets. As long as the central bankers can **carry the politicians and the public** (and they have a vested interest in easy money) then these sums will be deployed with devastating effect.

**Conclusion—Japan joins the party vindicating activism**

As the longterm nature of Japan's slump set in at the end of the 1990's extreme action was called for, and the BoJ became the first modern central bank to deploy QE and hence seek to expand the monetary base. But political paralysis sapped the energy from this policy leaving no substantive follow through.

In recent weeks with the US recovery now appearing to be on track, and with Europe drawing back from the brink after it's agressive spate of intervention, it is perhaps Japan's renewed establishment of a fresh round of QE together with an inflation target, that gives a vote of confidence in such measures.


BOJ balance sheet (source Bloomberg)

**'the Bank of Japan has opened its *sluice gates'* (Source Commerzbank 13/3/2012.)**

**Volcker moment—it's not just easy money**

This column has sought to explain just how important modern central banks, and their leaders are, to our market forecasting. But this is not just to say that this policy will always be in one direction, namely ultra-easy. When the 6ft 7 inch frame of Paul Volcker took the helm at the Fed, and immediately instigated a vicious round of tightening, it was clear that this policy had a profound effect on market. So we need to be alert to precisely this sort of eventuality.

**Fed/ECB/BoE/BoJ watching will tell us when this bull market has run its course.**

**Model Portfolio—stay the course**

Another month another bull run, is this too easy! With the best start to the equity market in 14 years (S&P) our bullish conviction has been well rewarded.

It can be tempting with this sort of move, and with some nice profits in our model portfolio to take profits. Of course a correction is overdue, and may come as markets adjust to higher prices. However we remain confident, and we expect further price rises throughout the year.

For this reason we will stick to our guns and make no change to our overweight positioning.

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