October 2012 Alvine Capital Newsletter

Power to the people, how politics intervenes

Key issues: overwhelming intervention by the world's major western central banks continues to mark the dominant theme in determining asset pricing. Democratic oversight of this process should not be ignored.

Key recommendation: politics intrudes by virtue of how central bank appointments and mandates are made. With the populace angry at lacklustre living standards, pressure will continue to make dovish policy and the continuation of easy money.

'Congress created the Fed. Congress gave us our mandate. If you determine that you want to change it, we will of course do whatever you assign us to do' Ben Bernanke (testimony to the House February 2012, source www.foxbusiness.com.)

As markets recover towards the 2012 highs, it has become increasingly obvious that the programme of aggressive quantitative easing will prevail over latent economic weakness. Even tensions in the Eurozone appear to be abating. As long as Bernanke/Draghi etc. Rule, investors can look forward to continued positive returns from financial assets, as the central banks are very much behind the market.

As the importance of these men dominates strategy, it is sensible to understand **who appoints and oversees, and for that matter, may replace these towering figures**. Likewise, while the bankers may interpret, it is parliaments that compose and have the power to vary the mandates within which they work.

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The market's most significant players—*but who is looking over their shoulders*?

The Federal Reserve - changes in mandate

Since the establishment of the Fed in 1913, the remit as established by statue, has changed on several occasions. The Federal Reserve act was 'to furnish an elastic currency' within the constraints of the gold standard. By use of the discount window and the twelve regional banks, changes in liquidity could be ensured. During the 1920's the Fed pressed the monetary levers by sterilising the amount of gold in circulation, this continued less successfully into the 1930's. During the war years the Fed guaranteed the prices of government securities to ensure the successful take up of Federal funding.

As the Fed's power grew, pressures within congress came to channel that force towards proactive political ends. In 1977 the Federal Reserve act was amended to incorporate resolution 133

'Maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to **promote effectively the goals of maximum employment**, stable prices and moderate long term interest rates.'

The dual mandate was born.

Unemployed men queue outside a soup kitchen in Chicago 1931

By citing this part of the dual mandate on frequent occasions the Fed has tended to pursue an interventionist agenda. 'Having the dual mandate makes it easier to justify additional stimulus', Dean Make, Chief US economist at BarCap (source: Bloomberg.com 22/1/12.)

But it is this part of the mandate that has caused much controversy. Republican congressman Kevin Brady has already moved a **'Sound dollar act'** (http://www.govtrack.us/congress/bills/112/hr4180) aiming to restrict future Fed action to solely inflation targeting (as do the Europeans). Support garnered from Republican backwoodsmen has been limited to little more than 30, suggesting that changes in this part of the Fed's mandate will be difficult to achieve.

However, the Republican mainstream has been voluble in demanding **changes in the composition** of the governors of America's central bank. Senator Tom Davis labelled Bernanke a 'traitor' and 'dictator' if he printed more money (which of course he has) while former Presidential candidate and Texas governor Rick Perry would 'treat him pretty ugly' (source: Market watch 26/08/12.) Most importantly Republican nominee Mitt Romney insists he will fire him. As his adviser, Lanhee Chen, pointed out '**we should be creating wealth, not printing dollars**' (source: politico.com 14/09/12)

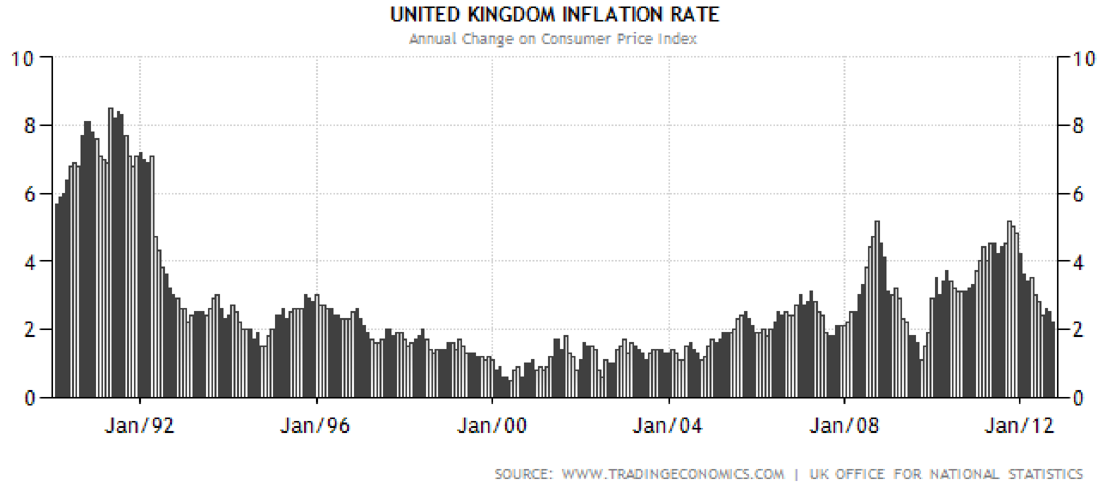
President Romney?

With the election result due shortly after the publication of this newsletter in early November, we have to take seriously the possibility of a new administration. While President Romney would be likely to work with the current Fed chairman in the short term, Bernanke's tenure is likely to be limited as re-appointment looms in January 2014. The President would also have an immediate opportunity to appoint one member due to a current vacancy, and in 2014 still early in his administration, choose the all important new Chairman.

'Whoever Mr. Romney names as Fed chairman, it is almost certain that he or she will take a more hawkish line on monetary policy', Bruce Bartlett former Senior Economist at the White House, commented in the FT this month going on to assert **'How Romney could end quantitative easing'** (source: FT.com 14/10/12.) This goes without saying will be paramount to the movement of asset prices.

Mervyn King and the Bank of England's mandate

New Zealand may have been the first central bank to fix an inflation target in 1990, but the UK's adoption of this ***single*** monetary objective was greeted with great fanfare in 1997.



A good first ten years of inflation targeting

During the first ten years of the mandate this target was fairly easily met, with the central bank having the guts to raise interest rates when required. However, since the financial crisis less and less care has been taken to stick to the necessary policy of tightening when inflation reappeared.

Samuel Brittan, writing in the FT this April, 'put the case for a 'dual mandate'' (source: FT.com 11/04/08), although his preference was not for the UK to include 'employment' but rather nominal gross domestic product. In other words, **if nominal GDP was weak then monetary policy would have to be accommodative.**

The **IMF** has also strayed into this debate on monetary mandates. Olivier Blanchard, Chief Economist, has floated the idea of **increasing the current target from 2% to 4%.** 'If we had had more margin to play with on interest rates, we would probably have had to use fiscal policy less' (source: FT.com 12/02/12.)

Mervyn King himself has seemed to find a solution to justifying a greater activist approach. In partly explaining the recent overshoot of UK inflation, and going on to predict an even more aggressive policy that could not be ruled out, Mr. King concluded it was right to **'aim off the inflation target for a while'** (source: CNBC.com 10/10/12.) With just a few months left of his tenure focus must now turn to his successor. Understanding whoever will be the next Governor will be a vital part of our focus.

Europe—it's *all* politics

Jens Weidmann - no stranger to the dark arts

Even without the benefit of hindsight, it should hardly be controversial to assert that the euro was very much a political creation. As Robert Cornwell titled an article prior to the single currency launch **'creation of the euro: political will triumphs over arithmetic'** (source: Independent.com 28/02/98.)

Many economists, pundits and investors have been caught out time and again missing that despite its many, and indeed deep seated flaws and inconsistencies, the euro will survive or fail based on political calculation. The interpretation of the ECB's own mandate has caused a great deal of controversy. It was the very *political* appointment of an Italian and MIT graduate, Mario Draghi, which should have alerted us as to how this process has eventually played out. 'The last four years have seen its mandate stretched to the limit as it struggles to save the euro. It has overseen the bailouts of three EU member states, spent billions on the bonds of debt-laden countries and given e1trillion in cheap loans to Eurozone banks', Jana Mittermaier, Director of the Transparency International EU liaison office (source: Euobserver.com 18/09/12.)

'Mario Draghi seems more sorcerer than central banker', The Economist (source: economist.com 15/09/12).

Conclusion: keep reading the politics

At various times the entire dirty business of politics may seem to be unimportant to the lofty world of investment strategy. It is often cited that whoever wins elections in this post communist world will face the same sort of policy dilemmas. Surely armed with the right analysis, economic models etc., we should be able to rely on drier expertise to guide us?

Political choices have become increasingly important to deal with the very great imbalances in our economies. Extreme levels of government debt, ageing populations with limited retained savings, together with the challenges of a globalised economy, have lent credence to extreme monetary policy.

Mitt Romney's exact policy workings towards greater fiscal and monetary rectitude still remain a bit of a mystery, perhaps even to himself. But the direction of this endgame is a sharp contrast to Obama's drift. This will provide us with a firsthand exercise in judging voters appetite for austerity, and it is for this reason that **we predict a comfortable, even if narrow, victory for the President**. In a democracy it is the politics that we must watch most closely.

Model portfolio

While 'quinfinity' continues to dominate investors' minds, many economists have questioned the effectiveness of this policy in terms of boosting the 'real economy.' This may be a legitimate worry.

However, Ben Bernanke in expounding his 'portfolio balance channel', the approach is much more akin to a market ramp. The Fed (and of course other central banks) will buy market securities and hence those investors selling will be likely to re-invest the funds into other assets. In this way securities will go up, allowing companies easier and better financing opportunities. Eventually this will foster an improved investment climate, and hopefully economy. This link to a recent FT article 'when markets drive the economy' is worth reading on this subject (http://www.ft.com/cms/s/e91f9c86-121f-11e2-b9fd-00144feabdc0.html).

So the market ramp is the policy. For this reason we remain overweight equities.

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