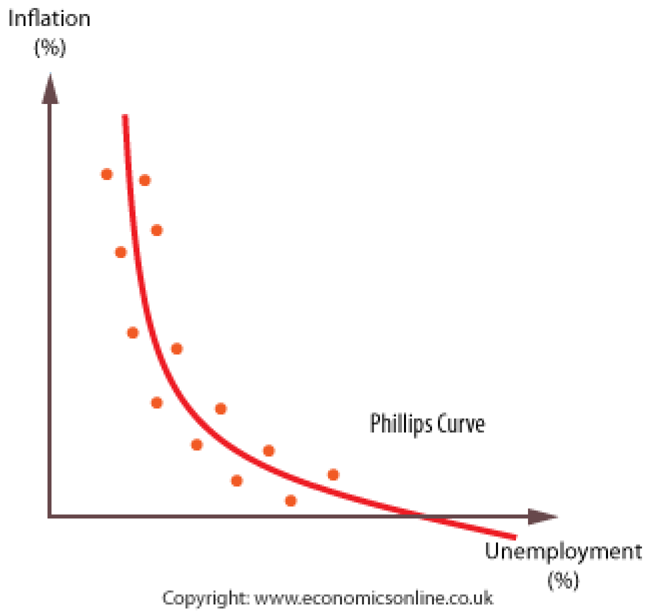
October 2013 Alvine Capital Newsletter

Humane monetary policy and unsound money

Key issue: With the nomination of Janet Yellen the appointments of ultra dove-ish central bankers are complete.
Key recommendation: The advent of unsound fiat paper money is now upon us. Only by maintaining a high proportion of risky assets can investors secure long term purchasing power.

The history of the human race has abounded with periods of the debasement of money, from the middle ages clipping of silver coins to the extremes of paper printing during the Weimar Republic. The last interval of sound money emerged after the ravages of the inflationary 1970's, and was spearheaded by Paul Volcker's Fed. Short term interest rates needed to get to 22%, which allowed 30 years of declining bond yields and quiescent prices ensued. This period has now come to an end with the populace combining with unscrupulous politicians to appoint a new generation of gullible central bankers. While consumer inflation may only rise slowly the ***gushing channel of money*** **will continue to flow into generalised asset price appreciation that can *still* astound us all.**

The Phillips curve - Unemployment or inflation?



It was simple - As **unemployment rises** extra capacity of goods and services are created due to a loss of aggregate demand. This over-capacity means **companies have to reduce prices** to maintain market share, hence inflation falls. Correspondingly as employment possibilities strengthen, **wages would increase** so boosting demand which would then filter through into **higher prices**. This version of the hypothesized trade-off originally described by **A.W. Phillips (1958) using U.K. data from 1861-1957,** this was viewed as a central tool for policy making purposes in the 1960's and 70's.

The Evans rule

The pressure for modern politicians, and the central bankers they appoint, to do something to solve an era of slow growth and persistent unemployment has lead to a resurrection of the Phillips curve as an apparent mechanism to formulate policy.

In searching for this formula the Federal Reserve moved beyond a more generalised easy money policy to set actual targets, or trigger points by which changes in policy would be made. These were set at the end of 2012 as **6.5% for the unemployment rate and 2.5% for PCE** (The Fed's favoured inflation measure) if either of those levels were not breached then monetary policy would remain unaltered. Until these knock

outs arrived then the Fed is **mandated to tailor an aggressive monetary policy**, so QE infinity was born. Since then unemployment has only moved lower slowly leaving this policy certain to run well into 2014.
"Imagine that inflation was running at 5 percent against our inflation objective of 2 percent. Is there a doubt that any central banker worth their salt would be reacting strongly to fight this high inflation rate? No, there isn't any doubt. They would be acting as if their hair was on fire. **We should be similarly energized about improving conditions in the labor market."** Charles Evans (of the Chicago Fed) himself explains why aggression in monetary policy is required (source: Business week 12/12/12.)

Forward guidance

Mark Carney - Champion both in Canada and now at the BOE

If the link between inflation and unemployment is a given, then a target can be given by which a rate of unemployment is set as *the threshold* for changes in monetary policy. The new Governor of the Bank of England has sought to take this one step further by ***estimating*** how long this might take, and hence **setting out the likely duration of the policy**.

This view was then taken that unacceptable unemployment conditions will last until 2016, 'Overall, my view is that the announcement has reinforced recovery' Carney (source: The Independent 12/9/13.) This will allow a greater certainty of policy, and hence it is hoped galvanise confidence.

Central bank alternatives - neglect and fail

While the Phillips curve may not always work, John Maynard Keynes was the quickest to explain the perils of deflation. Rigid inflation targeting can lead to a liquidity trap, and the underestimation of the dangers of a period of lack of demand. Twenty years of stagnation in Japan contrasts the work of the Fed and the BOE where aggressive monetary policy has become par excellence 'the most likely cause for deflation in Japan is a failure of monetary policy' NBER Takatoshi Ito (source: www.nber.org.)

Wrestling with extreme easing is one thing, but this contrasts with the early years of the great depression where sound money was elevated to an overriding art despite horrendous levels of slack in the labour market.

Andrew Mellon in-humane?—US Treasury secretary 1931
The preservation of the gold standard became a cross for those that believed capital as foundering if money was to lose its value. **"Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate**." That, according to Herbert Hoover, was the advice he received from the Banking scion Mellon, as America plunged ever deeper into depression (source: Paul Krugman NY Times 21/4/11**.) Is this the polar opposite to a humane monetary policy?**

Expecting competence from policy makers

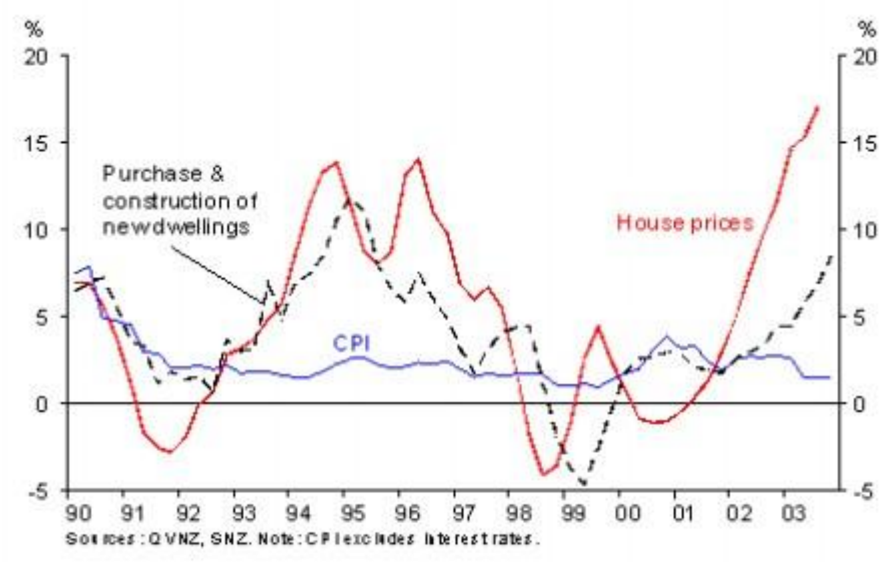
'It is conceivable that accommodative monetary policy could provide tinder for a build-up of leverage and excessive risk taking in the financial system. **Will future regulators and monetary policymakers be accused of bursting ten of the past two asset bubbles?'** Janet Yellen Presented on October 11, 2010 at the NABE Annual Meeting on the occasion of receiving NABE's Adam Smith Award for leadership in the economics profession.

The Chairman elect's question poses a challenge for central bankers to make adequate forecasts, in this case a failed to materialise asset bubble. This admits that poor visibility presents a reality in which monetary policy can never be a perfect science.
One source of persistent misunderstandings has been driven by a failure to see '**An average lag of about five or six quarters in monetary policy's impact on output growth'** (source: Reserve Bank of Australia discussion Paper 9702), rather than the minute-by-minute obsession of the current FOMC. Making policy on the hoof fails to take into consideration just how slowly the constituents of the economy actually modify and change their behaviour. Profound judgement is required, something made more difficult with the requirements of 24 hour news and the constant political pressure to deliver.

Ex-food, energy and assets

'In the US, the Fed considers that core inflation is a good predictor for future headline inflation.....core inflation is not necessarily a good predictor' Jean-Claude Trichet (source: moneynews.com 25/1/11.)
While it is fair that food can be subject to seasonal volatility and energy to the vagaries of Middle Eastern politics, these vital parts of consumer's lives cannot be swept under the carpet as being irrelevant. **They form part of the so vital to control inflationary psyche**.

However the most fundamental omission in better understanding economic cycles is the requirement to include some measure of asset price inflation or bust, into the monetary equation. From the wealth effect on households, stocks and share holders, to the credit quality of Banks collateral**, movement in asset prices should play a part in understanding the overall monetary requirements.**

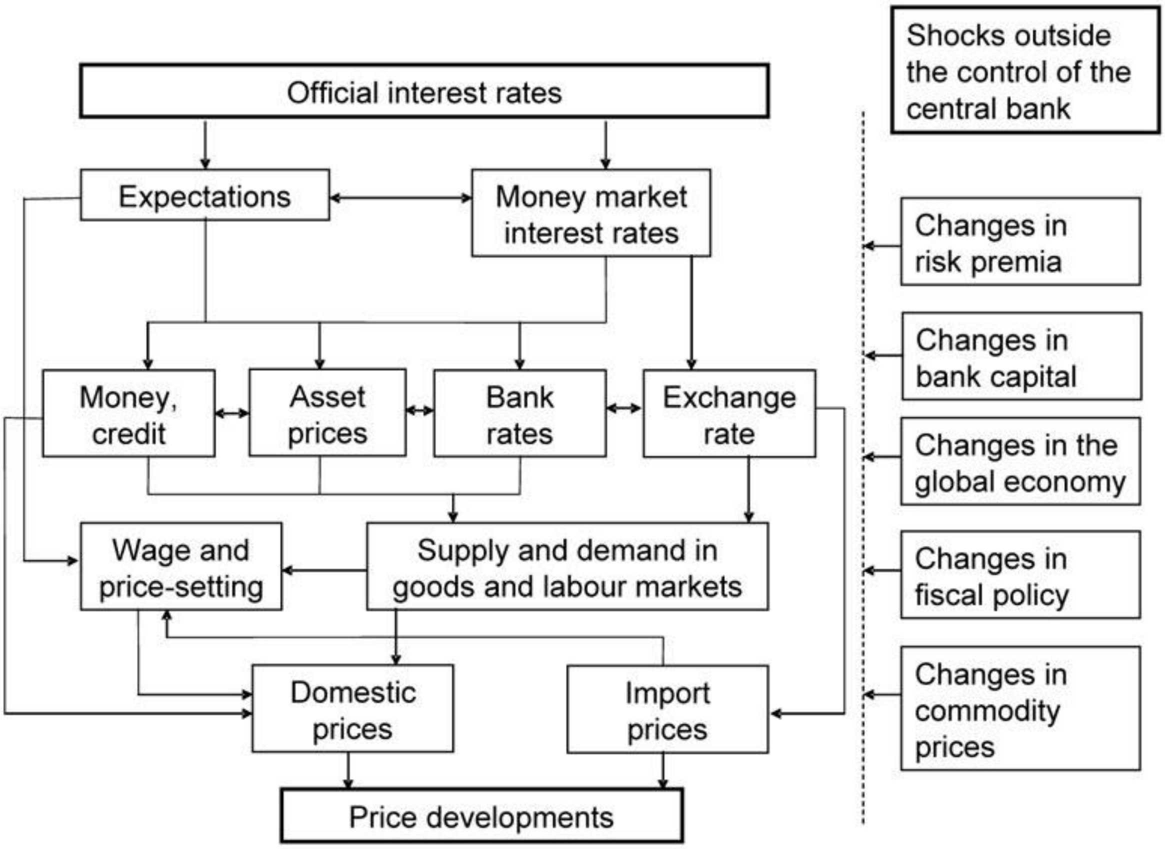


CPI was muted after the turn of the century, but the Fed was behind the curve choosing to ignore roaring house price inflation presaging trouble. **Anglo-Saxon Central bankers in particular, have been caught short time and again by underestimating total financial conditions in setting policy.**

Conclusion: The Phillips curve is inadequate

'The evidence suggests that the short-run Phillips curve is more likely to be useful for forecasting the direction of change of future inflation rather than forecasting the actual magnitude of future inflation' Kevin Lansing Federal reserve San Francisco (Fed reserve website 4/10/02.) Trying to simplify the working of the modern economy into a neat trade off between labour and prices seems to be a mistake.

Is this a better overview?



The Reagan and Thatcher supply side reforms of the 1980's were meant to once and for all put paid to the notion that active fiscal or monetary policy could somehow always compensate for a structural fault line of high unemployment. The imperative was to improve the speed limit for the economy by **de-regulating** impediments to growth allowing over a period of time, greater employment. **Control of inflation was never seen as a trade off** to this growth, but rather a necessary condition to allow businesses and consumers to better forecast the long term purchasing power of money. With low inflation greater investment would emanate, and this would spur activity.

However today's policy makers have reverted to old shibboleths citing the ongoing economic crisis, and we find ourselves back with a binary outcome. In pursuit of greater employment prospects, never ending stimulus of one form or other ensues.

Output gap and capacity: Globalisation, technology, over investment and the continued effects of the financial crisis have left a surplus of capacity for most products. Whether it is oil, copper, agricultural products, computers, cars or even lawyers, abundant capacity together with ruthlessly efficient supply chains means that we are not in the 1970's.

In the highly competitive modern world retail or consumer inflation is likely to rise only modestly. The cycle may have turned, but slowly. We are a world away from a trade union dominated labour market and other restrictive practises that really drove cost push inflation.

However, all this cash must go somewhere! This will flow into assets.

US real estate - rising faster than even 2006!

In 2006 the Funds rate was 5%, and there was no QE – now 0.5% and abundant QE, WHERE ARE PRICES HEADING NOW?

Financial assets are already enjoying an incredible bull run. This will continue. But now that most of the world's developed **economies have stabilised**, **and confidence is returning** the money will be there to fund wild bull markets across a range of classes.

Real estate, classic cars, fine art, premium wine, trophy assets, precious metals, bumper M&A deals, agricultural land and whatever can benefit from an abundance of money will become subject to rampant speculation along with of course risky financial assets.

This is another debasement of money.

Alan Greenspan complained about **'irrational exuberance'** when describing the excesses of the dotcom boom. Our current crop of bankers actually encourages asset price appreciation as means, perhaps the only way in their opinion, to filter through the effect of monetary stimulus into the so called 'real world.' Ben Bernanke called this **'portfolio channel balance'** it remains to be seen what fancy name will be coined by his replacement.

Model portfolio

We will make no changes to our equity overweight position and continue to ride this bull.

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