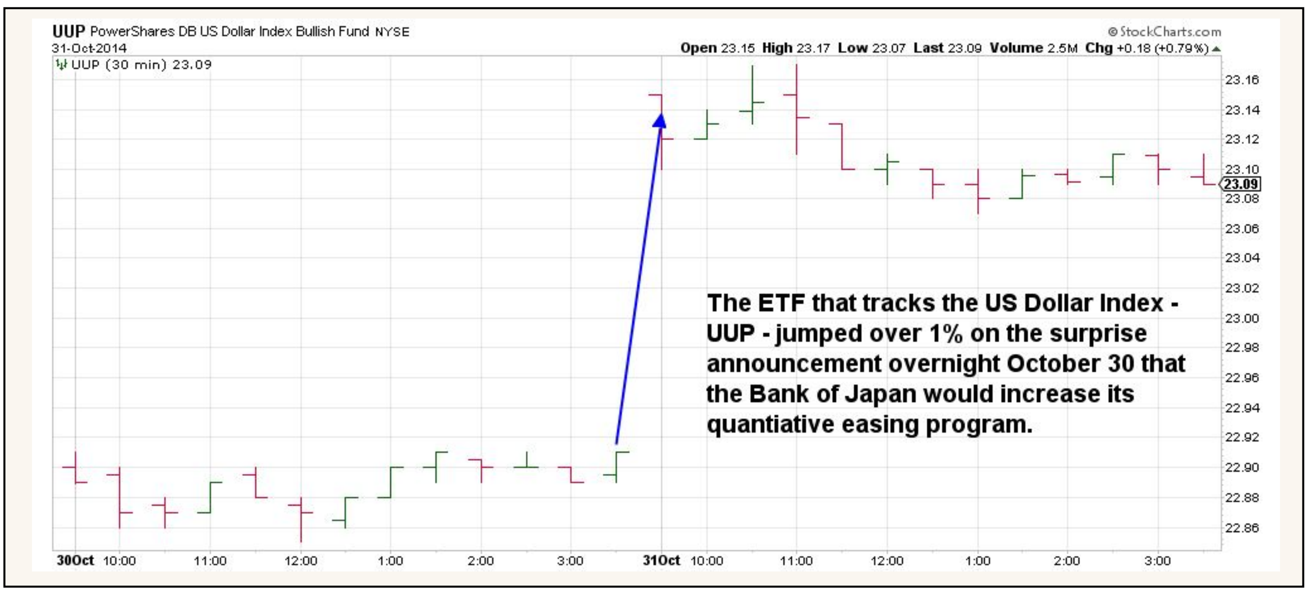
BUTLER, LANZ & WAGLER

November Newsletter 2014

Japanese Mega-Mega-Maxi-QE

On Friday October 31, appropriately enough on Halloween, Japanese monetary policy went from scary to horrifying. Overnight, the Bank of Japan announced that their already massive quantitative easing (QE) program would increase from 70 to 80 trillion yen per month. This announcement affected just about every asset class by the open of US markets on the 31st.



The ETF that tracks the US Dollar Index jumped 1% at the open Friday, and a 1% move in currencies is rare. The dollar-yen exchange rate makes up about 17% of the US Dollar Index, and the yen did not take the announcement very well.

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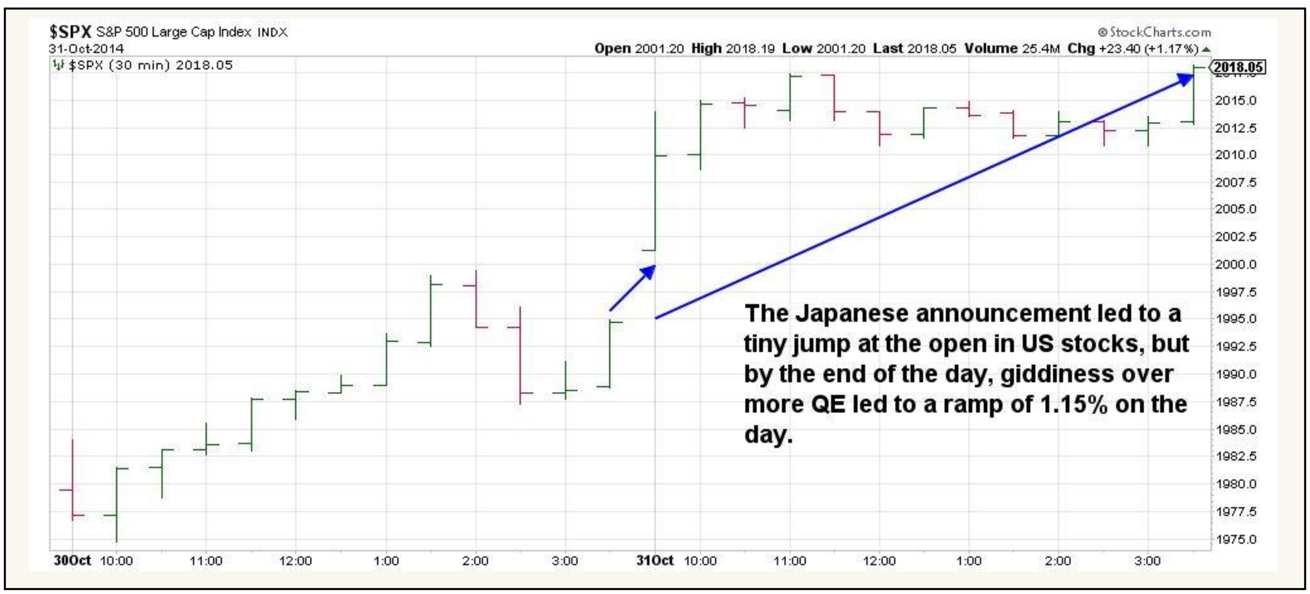
The chart above shows the yen lost 2.5% of its value versus the dollar at the US market open. More supply of yen, relative to dollars, will typically lead to a devalued yen.

The stage was set for all the usual "strong dollar" moves across the asset classes - gold down, oil down, and bonds up. However, the US bond market did not hold that initial euphoria, as money came flooding out of Treasuries to buy Japanese bonds. Stocks, of course, love quantitative easing and it doesn't seem to matter much who's doing the money-printing: the Fed, the European Central Bank or the Bank of Japan.



The S&P 500 finished up over 1% for the day October 31st. Why would the monetary policy in Japan impact US equity markets? The simple answer is that "everything's connected in a global economy." But that answer is too vague. The real reason US equity markets celebrated the Japan's latest attempt to destroy its own currency is because of the "carry trade." But before explaining that somewhat arcane topic, let's first see why printing more Japanese money does not buy more US goods for Japanese citizens. We'll use US stocks as our example of "goods."

Suppose a Japanese investor has ¥1,000,000 that he wishes to invest in Apple stock (AAPL). But to buy shares of AAPL on the New York Stock Exchange, he's going to have to use US dollars, so he must convert before he buys. On October 30, he could exchange each yen for 0.924 cents of US currency (1 yen is not even worth a penny). So, ¥1,000,000 would get him $9,240. If AAPL were trading at $100 per share, he could buy 92.4 shares of Apple stock (you can't really buy 0.4 shares of a stock, but let's pretend we can).

But our investor is a procrastinator. He decides that he'll exchange his yen and buy the stock on the 31st of October. Unfortunately, the Bank of Japan moved to destroy the value of his yen by printing ¥10 trillion more than the market thought, so, the yen lost some of its purchasing power. In fact, by October 31, our investor's ¥1,000,000 can buy fewer dollars. As of the 31st, each yen could buy only 0.89 of a cent. So the investor's ¥1,000,000 can only buy $8,900 and he can therefore buy only 89 shares of Apple stock. The point is, the mere creation of one currency in Country A does not buy more goods in Country B because the exchange rate takes the increase of supply in Country A's currency into account, and it gets devalued versus the currency in Country B. Japan will have many more currency units every month due to their QE program - in fact, more than previously thought. But they will not have more purchasing power.

So if stocks in the US are not reacting favorably due to the increase in the number of yen, why are they reacting favorably at all? That's because of the carry trade. We've talked about this in the newsletter before. The carry trade of choice over the last two decades has been to borrow money in Japan, at their barely-positive interest rates, convert the borrowed yen into another country's currency, and then invest the funds in markets of that target country.

For example, you can borrow ¥10,000,000 at 0.5% per year for 10 years in Japan. You will pay the Japanese bank ¥50,000 per year in interest and then the principal borrowed at the end of 10 years. You will take the borrowed ¥10,000,000 and exchange it for US dollars. At the current exchange rate, that conversion would yield $89,000. You can invest that money in any US market, but let's suppose you choose the Treasury market. You invest in the 10-year Treasury, which yields about 2.30% per year and matures in ten years.

You will make $2,047 per year in interest on your 10-year Treasuries. You'll have to use some of that to pay interest on the borrowed yen. And every time you pay the interest on the loan, the conversion rate will be different. That's the one of the risks of the carry trade. Right now, the ¥50,000 in annual interest you owe the Japanese bank will only cost you $462 of the $2,047 you've earned in interest on the 10-year Treasuries. The remaining $1,585 is gravy to you. Over the next 10 years, you'll make around $15,850 in gravy profits, depending on future exchange rates.

The final exchange rate risk you'll have to endure is when the Treasury note matures. At that time, you'll get your $89,000 back but you'll owe the Japanese bank ¥10,000,000. That loan re-payment may cost you more or less than the $89,000 you've received as proceeds from the bond maturation. That's a risk. But the exchange rate would have to move significantly against the dollar for this trade to be a loser because you'll have made around $15,850 in gravy profits in the ten years you've had the "carry trade" on. If the yen starts to gain value versus the dollar, many carry traders will simply close the position out by selling the Treasury bond and paying off the Japanese loan early.

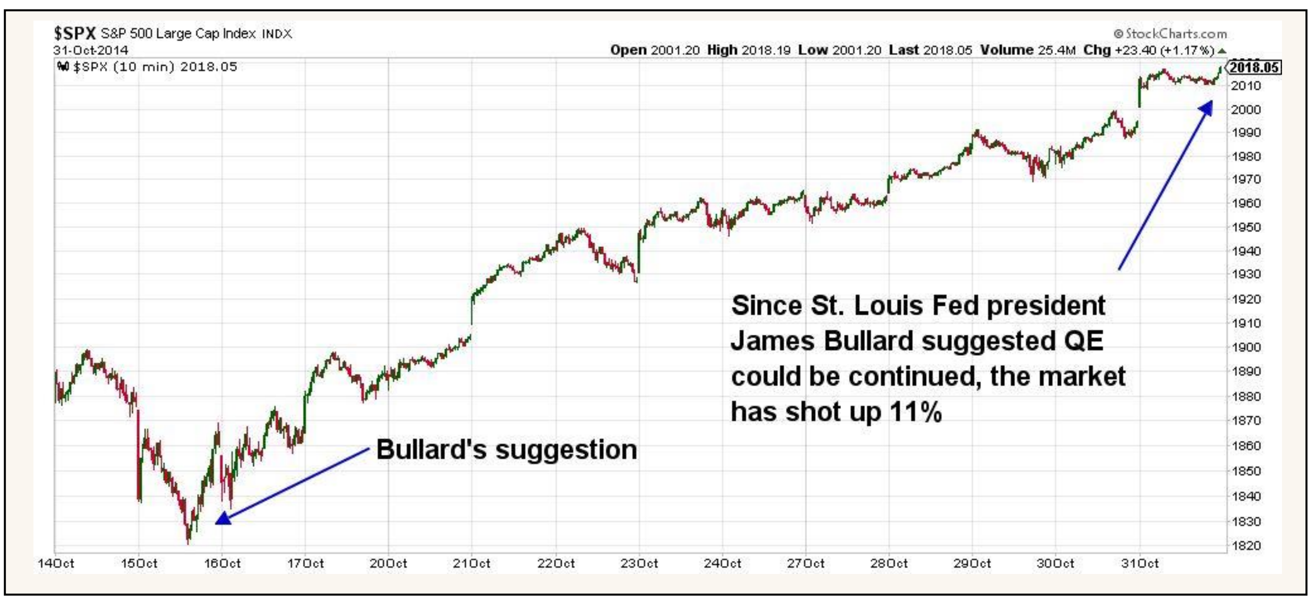
That's not a bad gig if you can get it. And hedge funds routinely do this with billions of dollars. The key to understanding market behavior is this: when the Bank of Japan prints more yen, they are buying more bonds. And when they buy bonds, the price goes up and the interest rate goes down. The lower the interest rate in Japan, the more profitable the carry trade is. Therefore, when the Japanese announce more QE, it means more carry trades and more investment in US bond and stock markets. In our example, we used the loan proceeds to buy Treasuries, but we could have just as easily bought stocks, and many hedge funds do just that. Hence, Japanese QE is favorable for all US risk assets.

October's Stock Market Rollercoaster

The stock market peaked on September 19th. It slowly edged downward through the last two weeks of that month and the first two weeks of October. Why? There were many risks that surfaced around that time that made traders take a pause. From a European recessionary threat to Ebola cases in the US, to the end of the Fed's quantitative easing program - they all led to a gloomy investor sentiment in October. And then oil prices started to break lower. Markets took this to mean that global demand was falling, a sign of economic weakness. Further, not only was the Fed's quantitative easing program ending in October, but members of the Fed seemed a little too hawkish given the economic landscape. More than one market pundit wondered aloud if the US economy was strong enough to withstand an interest rate increase as soon as late Q1 2015, which many Fed-heads seemed to imply was possible.

Many were expecting at least a 10% pullback from the September highs. During trading on October 15th, the S&P 500 was actually down 9.9% from that peak before reversing in a furious wave of buying. Why? Was there better economic news? No. Was there an onslaught of better earnings? No. But the market did get exactly what it wanted - promises from global central bankers that money-printing could be resumed if necessary.

The above chart tells you everything you need to know. Central bankers, primarily at the Fed, jawboned the markets higher with rosy economic statements and promises of more money-printing, if warranted. As the chart above shows, not all of their efforts were successful. It's interesting to note that St. Louis Fed president James Bullard may have gotten the sell-off going by hinting that the Fed should be less accommodative. In other words, the Fed should eliminate quantitative easing for good and start to raise interest rates. The market, understandably, hated that and took a nosedive. The market also was not in the mood for Janet Yellen's comments on the morning of the 15th regarding her faith in the US economic recovery. That simply means less money-printing. Ironically, it was Bullard who gave the markets the stick-save they needed later in the day on the 15th when he suggested that if things (the stock market) didn't get better, the Fed should consider delaying the end of QE, scheduled to end later that month. And then it was off to the races, as investors commenced what can only be described as a "buying panic." The S&P 500, since that "dreadful" 9.9% pullback can be viewed, in awe, below.



Since Bullard's suggestion on October 15th, the S&P 500 has gone up 11%.

The speed with which the S&P 500 made back its losses prompted many to suggest the Fed had more to do with the bounce-back than mere jawboning. John Crudele of the *New York Post* wrote on October 20th that "someone tried to rescue the market last Wednesday [October 15th]. And it's becoming a regular occurrence." That "somebody," in Crudele's estimation, is the President's Working Group on Financial Markets, or as they're commonly referred, the Plunge Protection Team. President Reagan formed the group to deal with stock market plunges like that seen in 1987.

The group is comprised of the chairpersons of the Fed, SEC, and Commodities Futures Trading Commission (CFTC) and the Secretary of the Treasury. Executive Order 12631, signed into law on March 18, 1988, gave the group three purposes: (1) maintaining investor confidence in US markets, (2) consulting with various major market participants to find private sector solutions to problems where possible, and (3) to keep the president apprised of any recommendations or suggestions.

Nowhere does the order give the group the express authority to "prop up" falling markets, but for at least 17 years, that has been widely suspected. Of course, it's doubtful many would find the government buying shares of the S&P 500 to be a "private sector solution." So it's unlikely any member of the group would ever admit to it if they had indeed been engaged in propping up falling markets by orchestrating the purchase of S&P 500 futures, which is what Crudele implies.

After the S&P 500 was down 45 points on the morning of October 15th, Crudele explains, "someone (or something) started buying S&P futures contracts en masse. Twenty-one minutes later, the S&P index had regained 30 of those lost points and was back at 1,861." Crudele implicates the Plunge Protection Team and makes a compelling argument. It's certainly rare to see a V-shaped bounce after such a drop, let alone an 11% move in 12 days.

Adding fuel to his story, Crudele points to an op-ed in the *Wall St. Journal* dated October 27, 1989. It was penned by the then-new Visa CEO Robert Heller, who had just left the central bank to lead the credit card giant. In the op-ed, Heller writes that "it would be inappropriate for the government or the central bank to buy or sell IBM or General Motors shares. Instead, the Fed could buy the broad market composites in the futures market." In other words, the Fed could buy S&P 500 futures contracts to influence market direction.

Certainly, these futures contracts are cheap and if a government, central bank, or the Plunge Protection Team were so inclines, they could turn around a whole stock market quickly, albeit not permanently. But they could at least allow the market to fall in a more orderly fashion. Heller's suggestion would indicate that, at the very least, the topic has been discussed at the Fed, and probably by the Plunge Protection Team. After all, the Chairman of the Federal Reserve is a member of that group.

Again, Crudele's argument is compelling.

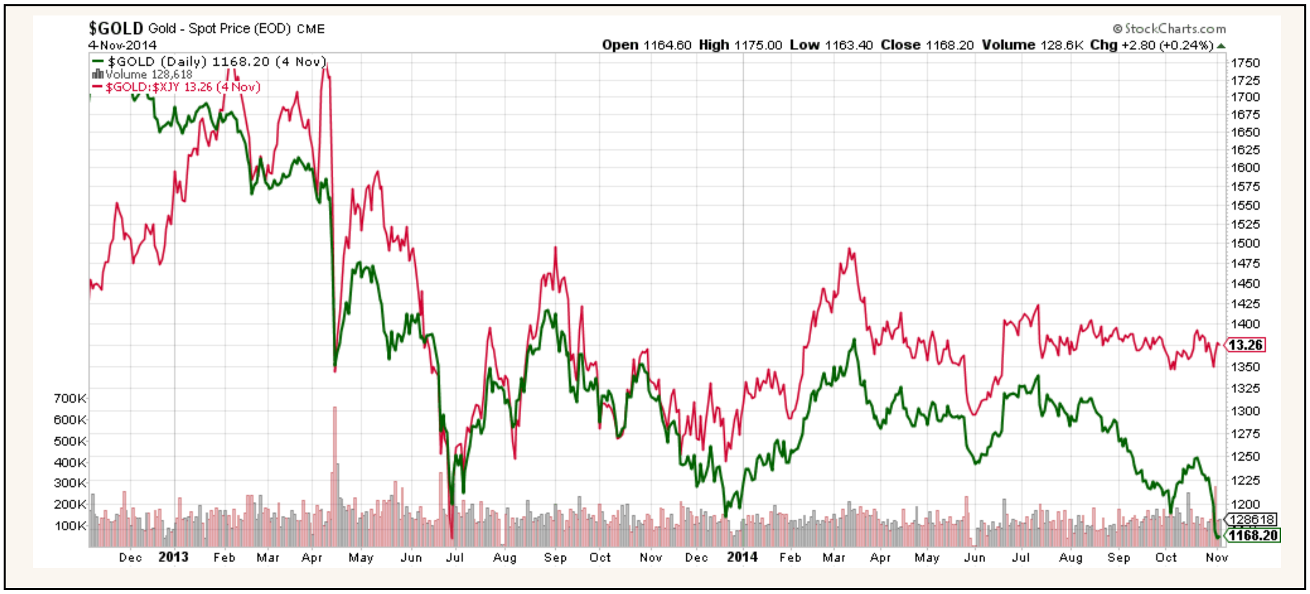
Gold is Not Glittering

Prior to the last week of October, gold had hit $1,180 per ounce three times, commonly referred to as a "triple-bottom" by technical analysts. Unfortunately, such lines of support rarely hold if hit a fourth time, which is what happened on the 31st. And it went through that price like a hot knife through butter. There was no support to be found.

There's been a lot said about why gold cannot seem to find a bid. But the culprit is fairly obvious to anyone with access to an internet-based charting service. Gold goes down when the value of the dollar goes up…generally.

Gold was already flirting with $1,180 when the Bank of Japan announced its mega-mega-maxi-QE "enhancement." That strengthened the dollar and sent gold below a price that had previously brought in buyers. It's all about the US Dollar Index. Short of all-out economic or financial panic, gold will not appreciate much, if at all, when the dollar is gaining strength.

What's interesting is that despite the Fed's massive QE, gold stopped appreciating in September 2011 - three years shy of the end of QE. But Japan has been engaging in a more aggressive QE program than the US starting in early 2013, and it has been supportive of gold in Japan. It has not jettisoned gold higher in Japan, but since the announcement of the new Japanese QE in April 2013, gold in Japan is flat to up a little. In the US, over the same time, it's down 15%.



Yes, most of this discrepancy is due to dollar strength versus the yen. However, gold is a competing currency to fiat currencies like the US dollar and the Japanese yen. At the very least, you'd expect the behavior of Japanese gold to be the exact opposite of US gold. That's not been the case. We think that it is now fairly obvious that gold is being "managed" by US and Japanese monetary authorities. We know that managing gold's price is an accepted, but rarely discussed, extension of monetary policy of global central banks. They are incented to do so as a rising gold price indicates a loss of confidence in the fiat currency of the country, and could lead to a currency crisis.

Then-Fed Chair Alan Greenspan, testifying before Congress in mid-1998 regarding the derivatives market, stated, "Nor can private counterparties restrict supplies of gold, another commodity whose derivatives are often traded over-the-counter, ***where central banks stand ready to lease gold in increasing quantities should the price rise*** [emphasis mine]." It can be no more plain than that. Of course, the Fed owns no gold. Central bankers manage the gold price. What constitutes "too high" a price is probably up to the interpretation by the Fed.

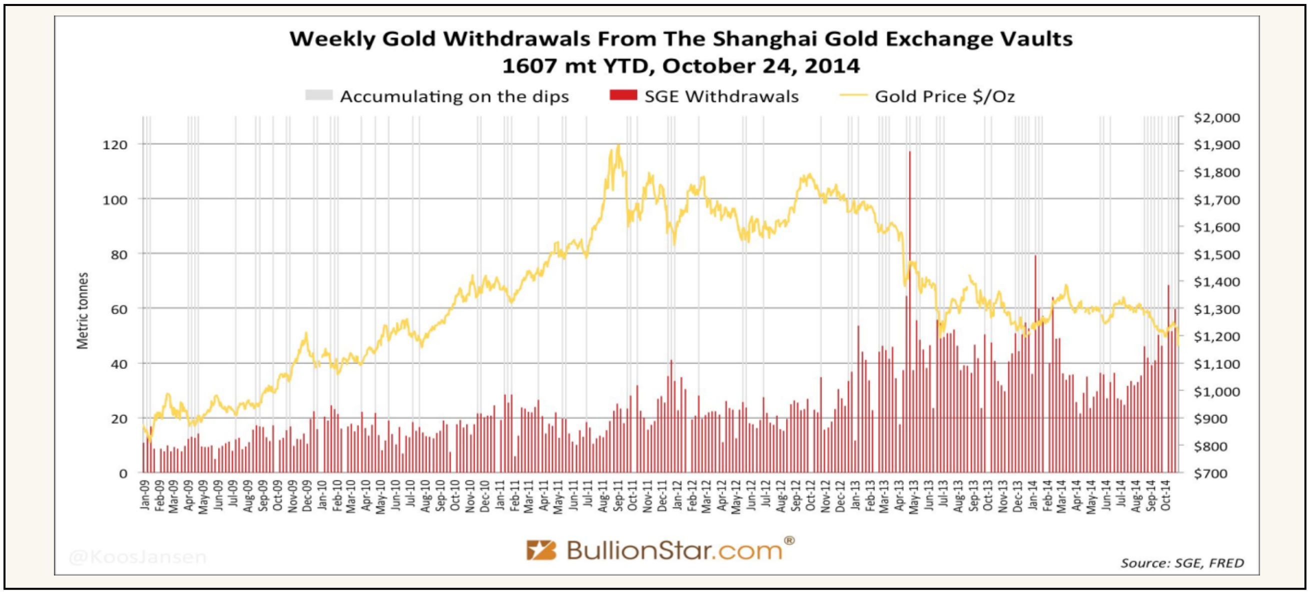
When gold gets hammered, one need look no further than the gold futures market during hours when the average American is in the third REM stage of deep sleep.

Most of you know that you can hear Butler, Lanz & Wagler's Chris Butler every Saturday morning at 8:00 on KCMO AM and 103.7 FM on *The Capitalist Pigs* radio show. But you can also hear Chris every Friday morning at 8:35 on Greg Knapp's KCMO Morning Show on the same stations.

One blog refers to this selling as the ubiquitous 00:30 gold "dumpfest." At 12:30 a.m. New York time, over the last several days, large orders to sell gold were entered. This also tends to be seen at 3:00 a.m. from time to time. If you actually held gold and wanted to sell it, why would you do it when the largest, most liquid markets in the world are in the US, and they're asleep? If you dump an enormous amount of gold that you own, would you not want to get the best price? The funny thing is that when you sell an enormous amount of anything when 90% of the potential buyers are asleep, *you will move the price down on yourself*, getting a worse sell price than you'd get if you just waited a few hours.

For that reason, we suspect that the seller of gold futures at 12:30 in the morning is (a) not actually holding gold (rather, he is naked shorting) and (b) actually wants to drive the price down. Central bank gold management? We'll let you decide.

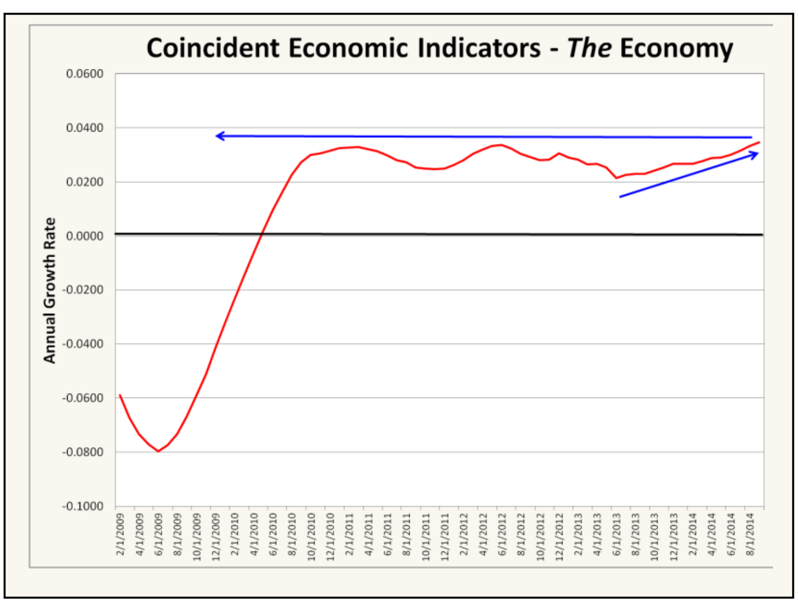
When the US futures price of gold falls, the world price of physical gold (gold bars and bullion) falls with it, as gold prices are set, unfortunately, in the futures market. So what do western investors do when the price of gold falls? They sell some more. Interestingly, when gold prices fall, Asians - eastern investors - buy at bargain prices.



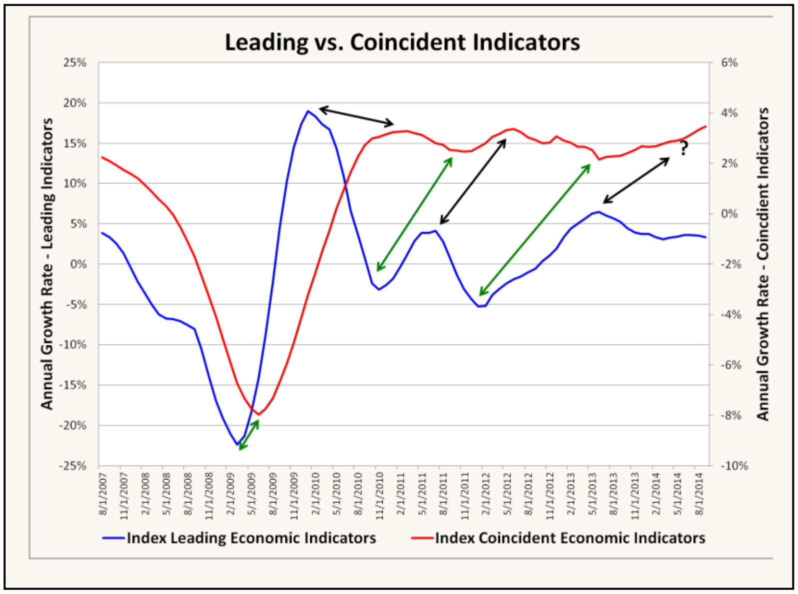
There has been no exception amidst this gold sell-off as evidenced by the spikes in the red lines at the bottom of the chart above. The gold price dips, the east buys, and the west keeps selling gold futures when we're asleep. There is a divergence between global supply/demand metrics for physical gold and the place where gold is priced - western gold futures markets. At some point, the discrepancy will be discovered by western markets, but it's anyone's guess as to when. Until that time, consider these facts. A falling gold price is consistent with the most recent supply and demand statistics published by the World Gold Council (WGC). However, as reported by the Chinese themselves (and they have an incentive to *under*-report their holdings), China holds about 1,150 tonnes more than the WGC reports. A falling gold price is not at all consistent with that demand statistic. Rather, it's rather consistent with a rising price.

The US Economy

Finally, the health of the US economy needs to be discussed. When you hear the financial press talk about "the economy," they're usually talking about coincident indicators - economic metrics that describe the economy itself. Some of the more common coincident indicators are employment, industrial production, consumer spending and GDP. Very rarely, if ever, will you hear one of these journalists mention the leading economic indicators which anticipate economic health in the coming 12 to 18 months. Investors, particularly stock investors, should be more interested in what's coming down the pike as opposed to current conditions. Current conditions have long since been factored into stock prices. Yet we're inundated with the status of US coincident indicators. There's actually a pretty good reason for that lately.



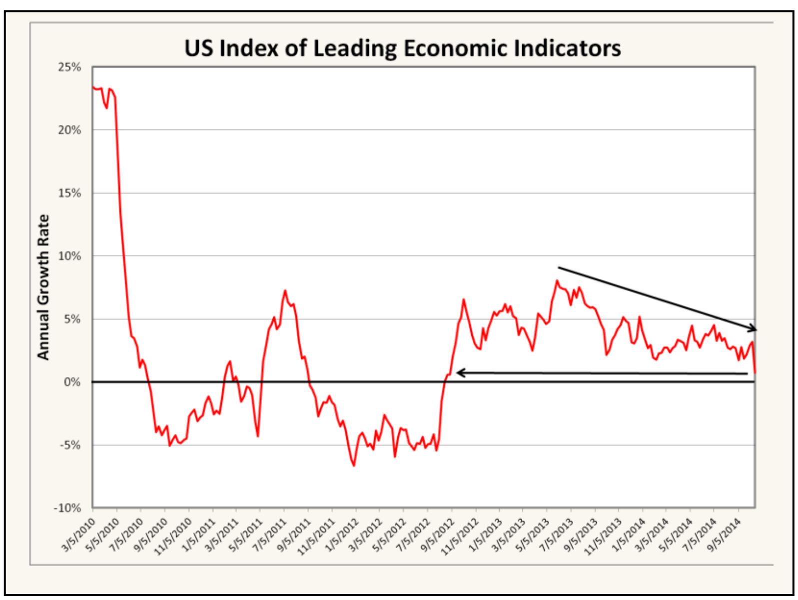
The US economy, as measured by the growth rate in coincident indicators, is in great shape, hitting a post-recession high in September. It's been accelerating since June of 2013 and that's fantastic news that warrants a great deal of coverage. However, in a somewhat rare divergence, the growth rates between leading and coincident indicators are diverging.



The chart to the left uses green arrows to show how the leading indicators lead coincident indicators at bottoms. Black arrows line up the tops. Overall, the leading indicators peak, on average, about 13 or 14 months before the economy - the coincident indicators. Leading indicators bottom, on average, about 10 or 11 months before the economy. Note that the leading indicators peaked in June of 2013. We were due for a top in the economy over this past summer, if we use average lead times. It still has not occurred. But it will.

There are some things in the economy that *must* occur prior to economic activity or growth. For example, a building permit *must* be filed before construction can occur. That's why building permits are a leading economic indicator. New orders must be received by manufacturers before they begin production to fill that order. That's why manufacturing new orders are a leading economic indicator. Other leading indicators are not absolutely necessary for future economic growth, but it would be strange for economic growth to occur without seeing these indicators move first. While it's not absolutely necessary that new business loans increase before the construction of new plants and the expansion of existing plants occur, it's the norm in a credit-based economy. Further, business loans usually increase before the proceeds can be used to hire additional staff. So, new business loans lead construction, production and hiring. That's why credit conditions are a leading economic indicator. Certainly, expansion can be funded with profit as it accrues to the firm, but it's much more common to see economic growth financed with credit.

All of that is important when interpreting the behavior of leading economic indicators. And one way to get a more real-time read on leading economic indicators is to look at the *weekly* leading index.



The growth rate of the weekly leading indicators is as low as it's been since the summer of 2012. And the growth rate itself is less than 1% annually. Does this mean a recession is in the offing? Not necessarily. But what it does mean is that it's almost impossible for the coincident indicators to continue accelerating when the front end of the business cycle is so weak. And, it means that future economic growth, over the next 12 to 18 months anyway, will likely be soft and disappointing.

Your investment decisions today should reflect that probably outcome.

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