

Tech Spotlight

Quantitative Easing II – it seems to be all the talk by the Fed, on financial shows, in media publications and on the many internet financial sites. Should there be more easing? Will there be a lot more easing? Is monetizing the debt a good thing? Is printing more money akin to “pushing on a string”? Have we done too much already? Are we going to have inflation or deflation? What asset classes should we be focused on?

Traders and analysts (at least those with more than just a few months or years of experience) pride themselves on the honing of their skills over decades of interpreting the likes of fundamental analysis, economic data, geopolitical events, technical levels and investor reactions/emotions to the markets. They (we) get frustrated (remember the John Maynard Keynes quote from last month) when most of these skills seem to get thrown out the window, however temporarily, when markets begin to all react to one single item. In this case, and for the past few months, it is the US Dollar.

Normally we begin this piece with a look at the Dow Jones Industrial Average (DJIA) and, as we did last time, the Standard & Poors 500 Index (SPX). This time, we will start with a look at the US Dollar Index (DX) and revisit the Velocity of Money piece we wrote about back in June. Then we will take a quick look at the DJIA, the SPX and the interest rate yield on the US 10-Year Treasury Bond. I do this because the movements of most other asset classes that we “keep an eye on” seem to be moving exactly inverse to the direction of the US Dollar. This is not always the case, but it has been the case since the beginning of July and in virtual lock-step since the beginning of September when talk about Quantitative Easing II really started to heat up.

So first, we’ll take a look at a long-term chart of the US Dollar (DX). As we have written a number of times now, the US Dollar has been in a long-term downtrend since 1985. Though in a long-term downtrend, the US Dollar has experienced a number of significant counter-trend moves. The question we and many others here in the US and around the world would like answered is whether the Dollar will continue in the downtrend, or, will it rally and regain some of its old “luster”? There are serious implications for all concerned.



When we last saw this chart at the end of June the DX had rallied almost 20% from \$74.23 in November 2009 to \$88.71 in June 2010 (blue arrows in the chart above and the chart below).



As you can see in the shorter-term chart of the US Dollar above, the DX broke out above its short-term downtrend line and with all the news of sovereign debt problems in Europe unfolding (remember all the talk about Portugal, Ireland, Italy and Greece during the first six months of 2010?) it appeared the DX was poised, after perhaps some rest and consolidation, to eventually test the longer-term downtrend line around \$95 in the first chart shown above.

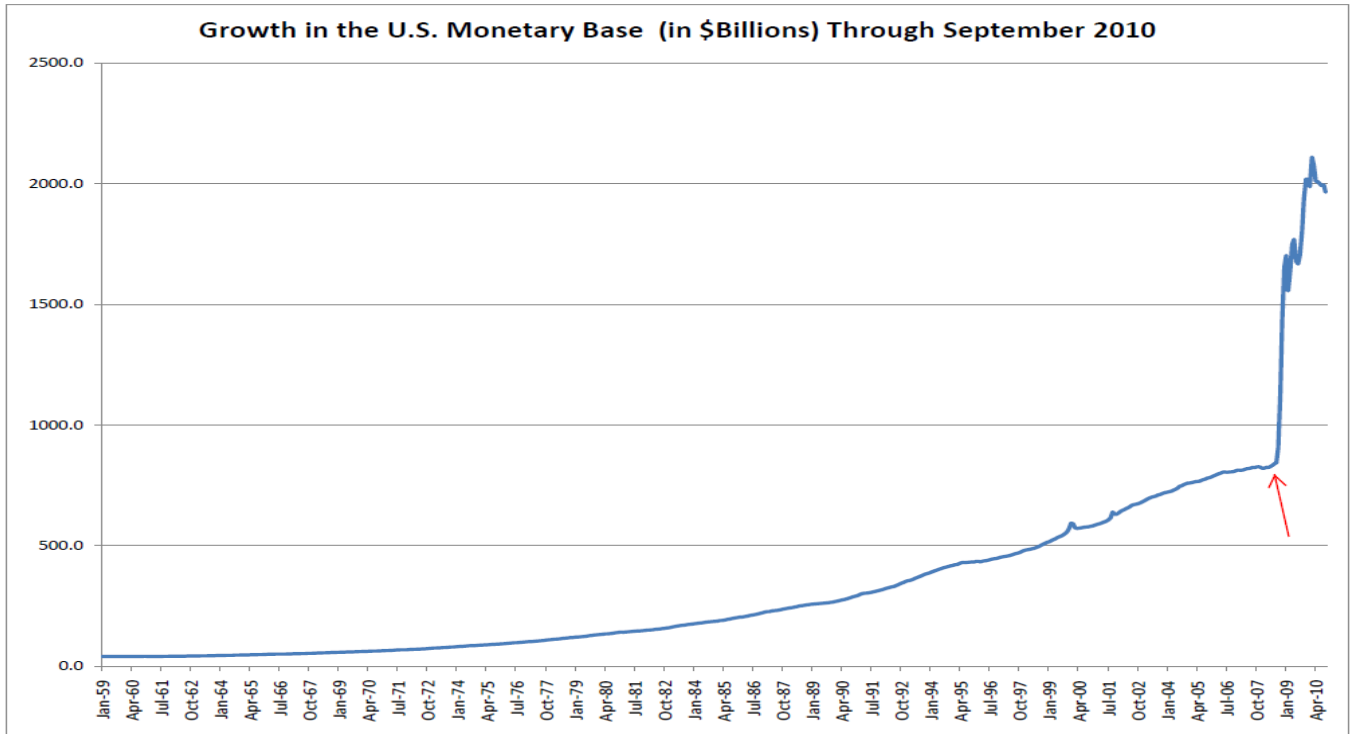
However, financial news out of Europe has quieted down significantly over the summer and talk of quantitatively easing in the US has heated up (the purple arrow above) all leading to the US Dollar correcting down a little over 14% .

The talk of quantitative easing has currently acted to weaken the US Dollar. This has the beneficial effect of making US export goods relatively cheaper in the rest of the world which helps US companies with their global sales and making it easier for them to add to their bottom lines. It is tough on those foreign companies that export their goods into the US as their goods become more expensive. It also has the short-term effect of making oil and other imported commodities more expensive (remember, imports into the US are now more expensive due to the weaker dollar). This is why the price of gold has been moving up and not so much because of any near-term inflation fears.

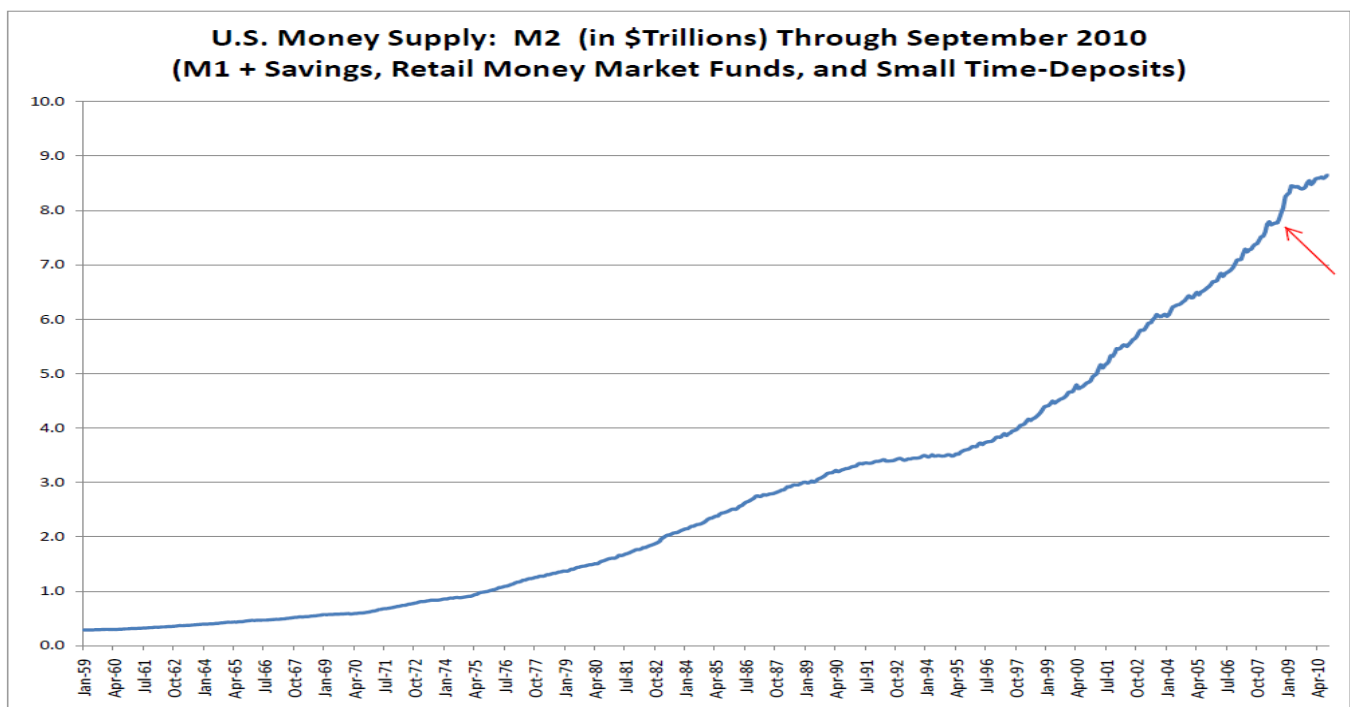
Because virtually all other asset classes are following the inverse lead of the US Dollar, we fix our eyes on what will happen at the green uptrend lines of the short-term chart (around \$76) and long-term charts (around \$69) above. Should the US Dollar break down through these levels, we would expect to see the US Dollar weaken considerably which could lead to higher commodity import prices and cheaper export goods – a two-edged sword. If the US Dollar were to break out above both of the two red downtrend lines (around \$82 in the short-term chart and \$95 in the long-term chart) it might signal some uncomfortable things are happening in the world's non-US markets. In between, there is a lot of room for movement and its corresponding volatility in the various financial markets.

One of the concerns with all the talk of quantitative easing is about inflation. We addressed this to some degree back in June and will update the charts we were looking at then involving the US Monetary Base, the Money Supply (M2) and the corresponding calculation of the Velocity of Money.

As we wrote in the June issue, the Monetary Base grew at an average annual rate of 6.3%, with little variance, for almost 50 years into the middle of 2008. The Monetary Base was at roughly \$843 billion in August 2008 (red arrow in the first chart below). But with the credit crisis exploding in September 2008, the Federal Reserve and the US Treasury went into overdrive and grew the Monetary Base by almost 150% in the following 18 months to roughly \$2.1 trillion. Since then, the Fed has slowly pulled back \$150 billion, leaving the Monetary Base at \$1.964 trillion. And now they are seriously “hinting” that they wish to increase the Monetary Base by \$500 billion to \$1 trillion over the next year or two. Talk about the potential for runaway inflation would really begin to heat up at some point with such growth in the Monetary Base.

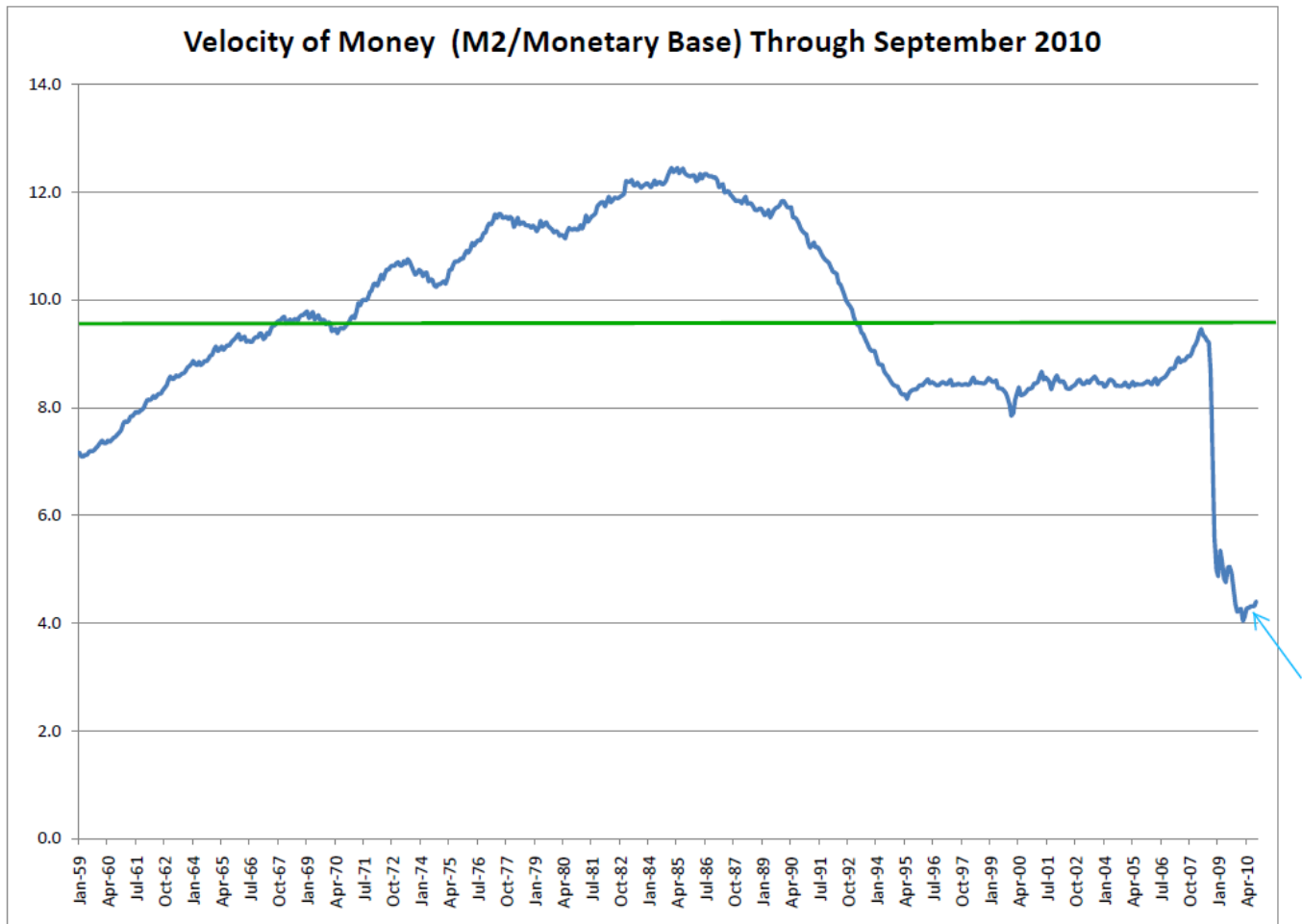


But, as we discussed in June, it is not all about the size of the Monetary Base. The size of the Money Supply (we'll use M2 for purposes of our discussions here) also has a lot to do with inflation expectations.





As we discussed in June, we have yet to see much inflation because the Velocity of Money (VOM) has dropped enough to offset the rise in the Monetary Base. VOM is simply the ratio of M2 to the Monetary Base (M2/MB). This ratio is reflective of the movement of money through the economy – how fast does money change hands, so-to-speak. Consider the updated chart below of the Velocity of Money (going all the way back to 1958):



The light blue arrow marks where the VOM was at the end of June. As you can see, the VOM has barely moved up, from 4.3 to 4.4. The green line represents the average VOM since 1958 which is approximately 9.64. From a purely technical viewpoint, I find it rather interesting that the green average VOM line virtually acts as a resistance line for the VOM. Once the Velocity of Money calculation got back to the average it quickly turned “south” and fell away to levels not seen since the 1930’s and 1940’s.

Getting back to inflation ...

The thinking is that as the VOM increases then inflation rises with it (please refer back to the June issue for a fuller explanation). Now remember, the Federal Reserve has two legislated goals: price stability and full employment. Our thinking is that the Fed, **at least in the near-term**, more than likely feels/expects the VOM to stay low and perhaps even move lower allowing for additional quantitative easing without fears of significant inflation. This would imply that their main concern is employment which is somewhat dependent on a stable, if not growing, economy. The Fed is concerned about the economy, otherwise why talk about additional quantitative easing? But they are concerned about inflation down the road. Hence the problem – if the Monetary Base is allowed to grow at a pace way beyond the growth rate of the past 50 years, how do they time the reduction of the Monetary Base in the future once the Velocity of Money begins to pick up? Consider the following comments by Fed Chairman Bernanke in a speech he gave last week on Friday, October 15:

“However, possible costs must be weighed against the potential benefits of nonconventional policies. One disadvantage of asset purchases relative to conventional monetary policy is that **we have much less experience in judging the economic effects of this policy instrument, which makes it challenging** to determine the appropriate quantity and pace of purchases and to communicate this policy response to the public. These factors have dictated that the FOMC proceed with some caution in deciding whether to engage in further purchases of longer-term securities.

Another concern associated with additional securities purchases is that substantial further expansion of the balance sheet could reduce public confidence in the Fed's ability to execute a smooth exit from its accommodative policies at the appropriate time. Even if unjustified, such a reduction in confidence might lead to an undesired increase in inflation expectations, to a level above the Committee's inflation objective. To address such concerns and to ensure that it can withdraw monetary accommodation smoothly at the appropriate time, the Federal Reserve has developed an array of new tools.² With these tools in hand, **I am confident that the FOMC will be able to tighten monetary conditions when warranted**, even if the balance sheet remains considerably larger than normal at that time.”

I would like to be a fly on the wall at the next Fed meeting on November 2nd (election day) and 3rd to listen in on their discussions about this next round of quantitative easing. It would be hard to believe that all the Fed members are in total agreement about what to do.

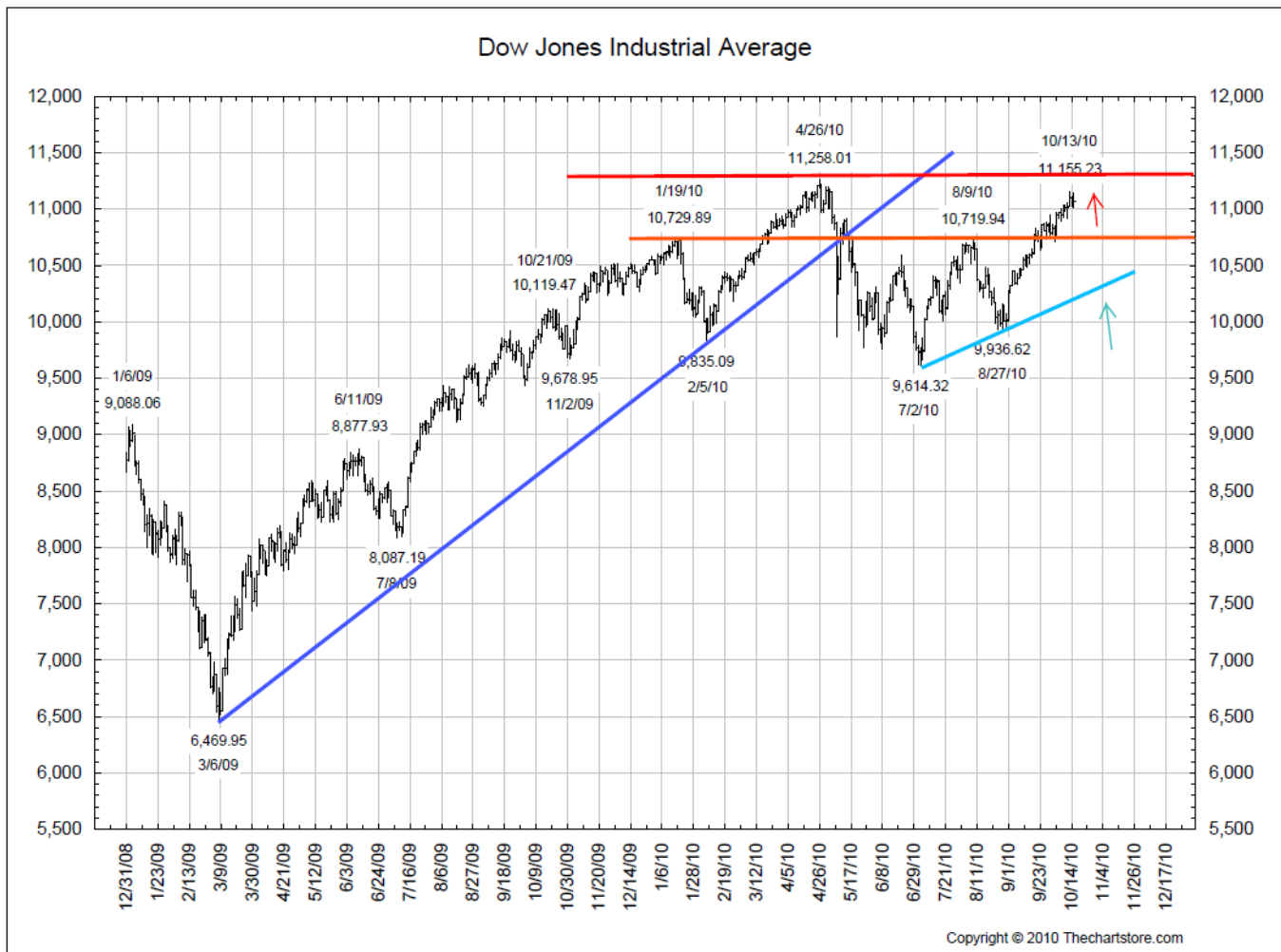
It may seem like enough to focus on what the Fed is thinking and what they may or may not do, but there is an even bigger picture – how US actions on this matter affects the strength or weakness of the US Dollar versus other currencies around the world. Finance Ministers and Central Bank Governors of the G-20 countries are meeting today and tomorrow in South Korea to discuss currency issues. For obvious reasons, all countries are worried about price stability and employment, and each would like to have a weak currency so their country's exports will sell better in global markets. These talks will help set the agenda for the November 11-12 summit of the G-20 leaders.

Reaching a consensus for relative currency values and trade balances appears to be very difficult right now as everyone is concerned about their economies “back home”. It seems as if most countries are focused on growing their economies from exporting and not from internal growth in “local” spending. Without some kind of agreement, the result could be currency wars which may lead to trade wars – not a pretty picture. And we don’t even want to begin talking about the tens of trillions of dollars in currency derivative contracts that exist around the world.

Consequently, you may begin to understand our current focus on the US Dollar and other currencies that we are watching.

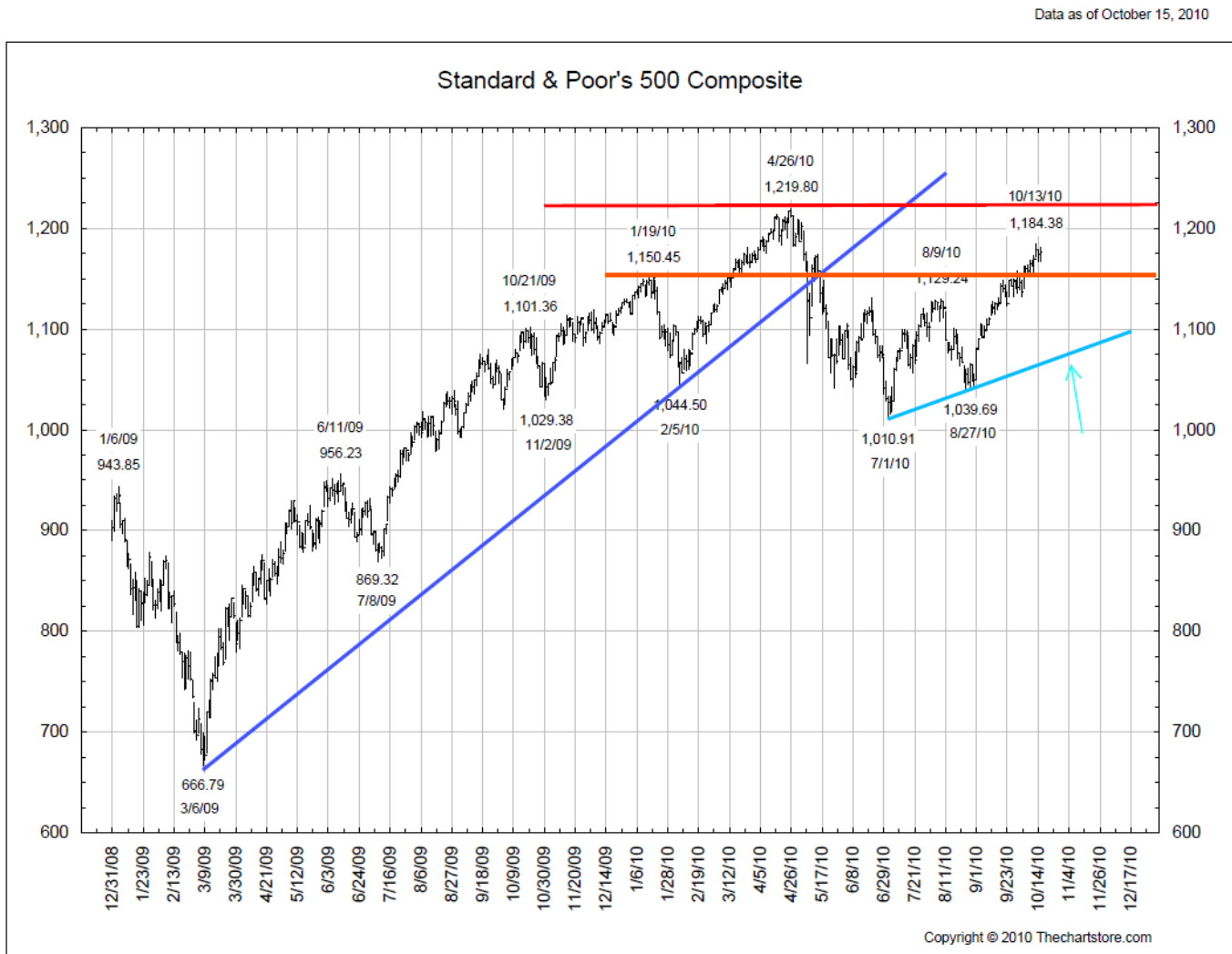
In the meantime, what is happening with the US stock markets? We’ll start with the chart below of the Dow Jones Industrial Average (DJIA):

Data as of October 15, 2010



As you can see, the DJIA has broken out above its July-August rally high and seems intent on testing the April 2010 market high of 11,256. Breaking above this level could send the stock markets into overdrive and begin a climb toward the old 2007 market high. So, for now, we look to see what the DJIA will do if it gets to 11,256 (the red resistance line and the red arrow) or whether it corrects down some and then we look to see what happens at the light blue support line at around 10,300 (light blue arrow). This gives a 900 point range that for all intents and purposes gives the DJIA index room to “play around in” until it decides which trend it will set – a continuation of the uptrend began back in March 2009 or a continuation of the downtrend that appeared to begin in April 2010.

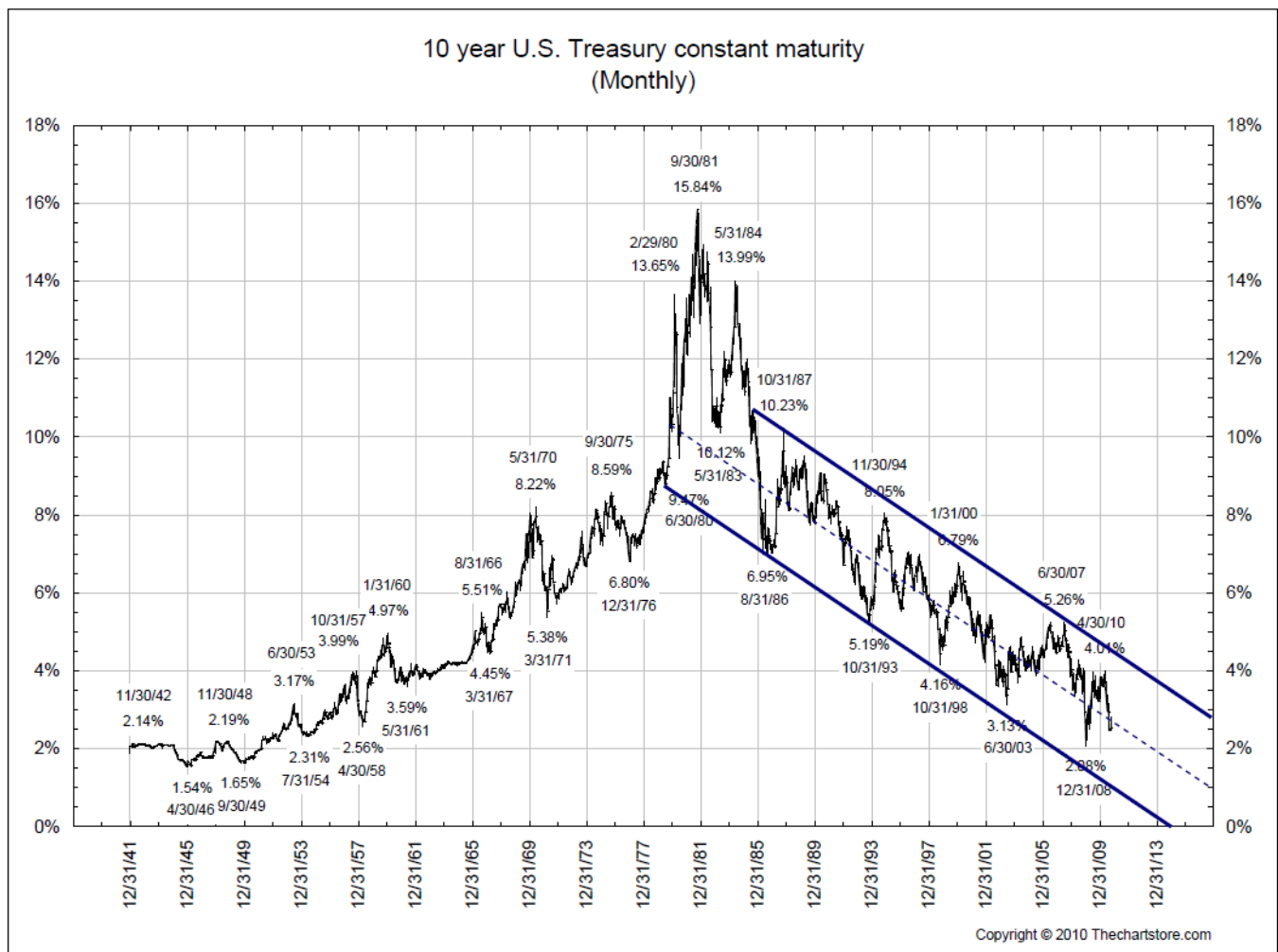
The chart of the Standard and Poors 500 Index (SPX) gives the same story:



The SPX has also broken out above its July-August rally high and is looking towards its April market high of 1220. But it is a bit further away from getting there. Its “free play zone” is between 1220 (the red resistance line in the above chart) and 1070 (the light blue arrow along the light blue support line).

The best thing to do is to wait for the charts to tell us what the trend (either up or down) will assert itself. If we were to try and look for clues to what may happen, we have to look no further than a chart of the yield for the 10-Year Us Treasury Bond (TNX):

Data as of September 2010



Given the relationship between the chart of the SPX and the TNX we discussed in last month’s issue, we would expect to see money flowing out of US Treasury bonds as the stock market



indices rise. However, what we have seen since the overall stock market top in April 2010 is a continual flow of funds into US Treasury bonds. With the stock market fall beginning in late April this would make sense. But with rise from the July 1-2 stock market bottoms, there has been a continued flow of money into US Treasuries. Part of this can be explained by the Fed's talk of additional quantitative easing which could result the possible purchase of US Treasuries by the Fed. But some of it is not. Temporarily, at least, traditional asset relationships are out of sync. We'll wait to see whether they will eventually resume or whether a "new normal" will take hold.

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Managing Partner



TECHNICAL ANALYSIS

Seeks to define the trend of various markets, be it short-term, intermediate-term or long-term.

Remember, markets never move straight up or straight down, they move more like the ocean tides, surging (trending) up or surging (trending) down until the tide changes direction. We use various chart time horizons to give us an idea of how far a wave will move within a tide. Our intent is to keep clients apprised of changes in the various markets' movements in the months and years ahead.

Technical Analysis operates under three Basic Premises:

1. Market Action discounts everything. Or ...

Supply Versus Demand governs market action.

2. Prices move in trends. And ...

Trends stay intact until broken.

3. History often (but not always) repeats itself. Or ...

At the very least, it sure seems to rhyme.

The study of charts is based on the evaluation of past events to determine future probability. We seek a stock, or other asset or financial instrument, forming a particular pattern. We note that this pattern resembles that which typically precedes an asset's upward or downward move. In this way we are able to use our knowledge of the way a particular asset has acted in the past to estimate this particular asset's most probable future move. There will be a rational, logical and fundamental explanation for a particular chart formation usually following a given move in price.



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