CURRENCY CURRENTS

A free global-macro & market newsletter

BLACKSWAN

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Quotable

"Shut up! Shut up! I am busy. I am working Cape Race!"

- John Phillips (chief radio officer aboard the Titanic), in reply to Cyril Evans' final ice warning.

Commentary & Analysis

Same old solution is a setup for 5,000 on the Dow. Crazy, I know!

You remember the old lawyer joke: Why do researchers prefer to use lawyers instead of rats in laboratory experiments? Because there are certain things rats won't do! Well, it seems rats are now running from the sinking ship. One can only hope lawyers remain onboard so we can call it a "good start" (nothing like a little lawyer humor to get one going on a Monday morning)!

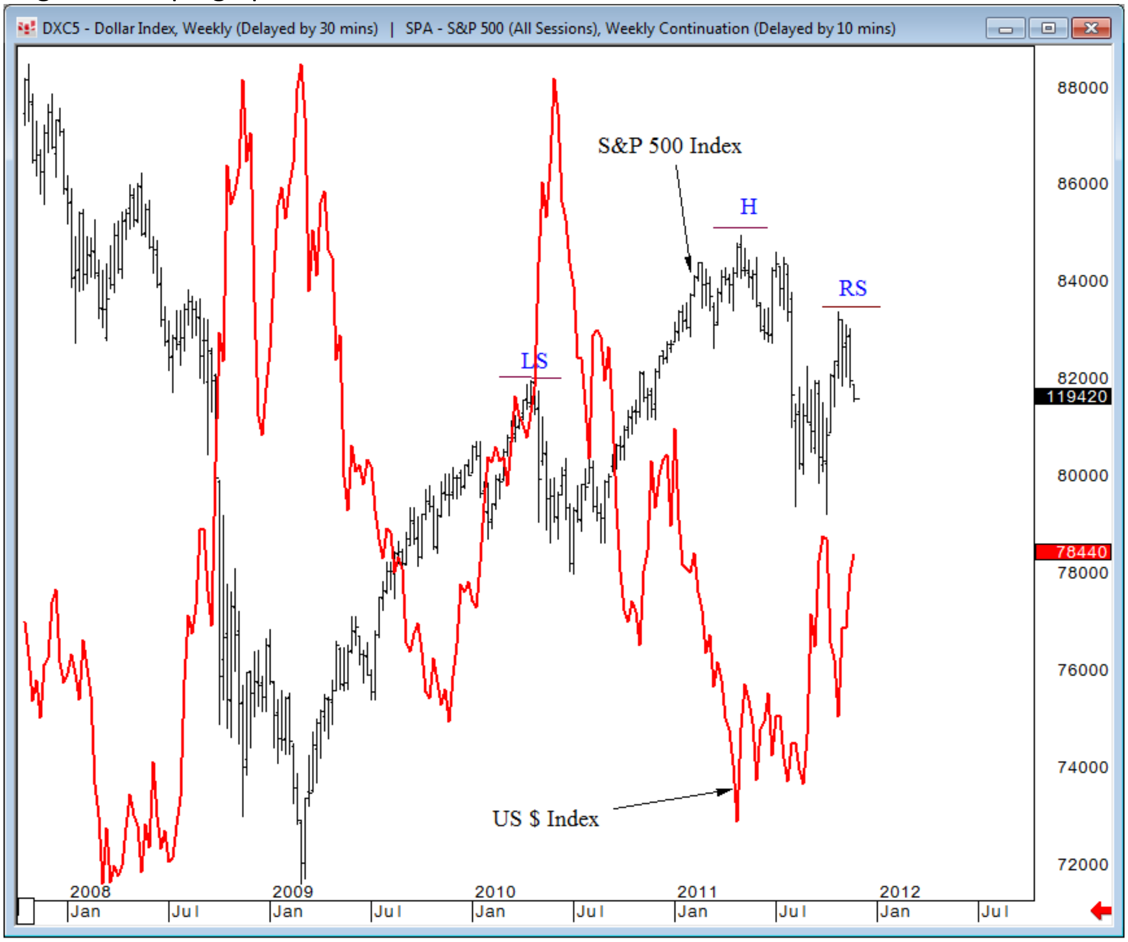
It seems we are all conditioned for good reason to believe we are trading in a pure "risk on" or "risk off" market. We seem to just accept that central bank liquidity will pull us through, but volatility could be fierce in the meantime.

A few salient points I think:

1. Banks are holding more dollars in general; as are many other institutions worldwide; thus why all the so-called US dollar reserve increase is not leading to inflation.
2. European banks are now scrambling for dollar credit and building dollar reserves; they are not in the lending mode. Thus, this should intensify the Eurozone recession.
3. Falling stock market values in Europe is destroying existing collateral (I think from a real economy feedback loop we often lose sight of the fact that besides being a casino for high frequency trading, stock markets are also the world's largest repository of collateral).
4. The US current account is improving; effectively that represents dollar supply draining from global markets; the last thing China needs.
5. France warned by Moody's about a possible downgrade; which would effectively nullify the European Financial Stability Facility as it is predicated on French and German AAA-rating status. French banks, some of the world's largest, would drain credit lines faster on this event.

It is the stuff that supports our intermediate-term view—stocks down and dollar up—“risk off”; nothing new here as we know the tight negative correlation between the US dollar and risk assets:

S&P 500 Index Weekly versus US $ Index: Notice the nice head & shoulders pattern that might be shaping up in the S&P…



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…as I said, nothing really new here in these charts…but there is nothing new flowing from world leaders in an effort to fend off yet another bout of “risk off” and a nasty contagion except the same old policy; this time with the ECB taking a broader role:

Get the Fed and ECB to buy huge amounts of bonds is the déjà vu all over again solution to our woes. It’s been a movie played twice in the US so far and is ending badly.

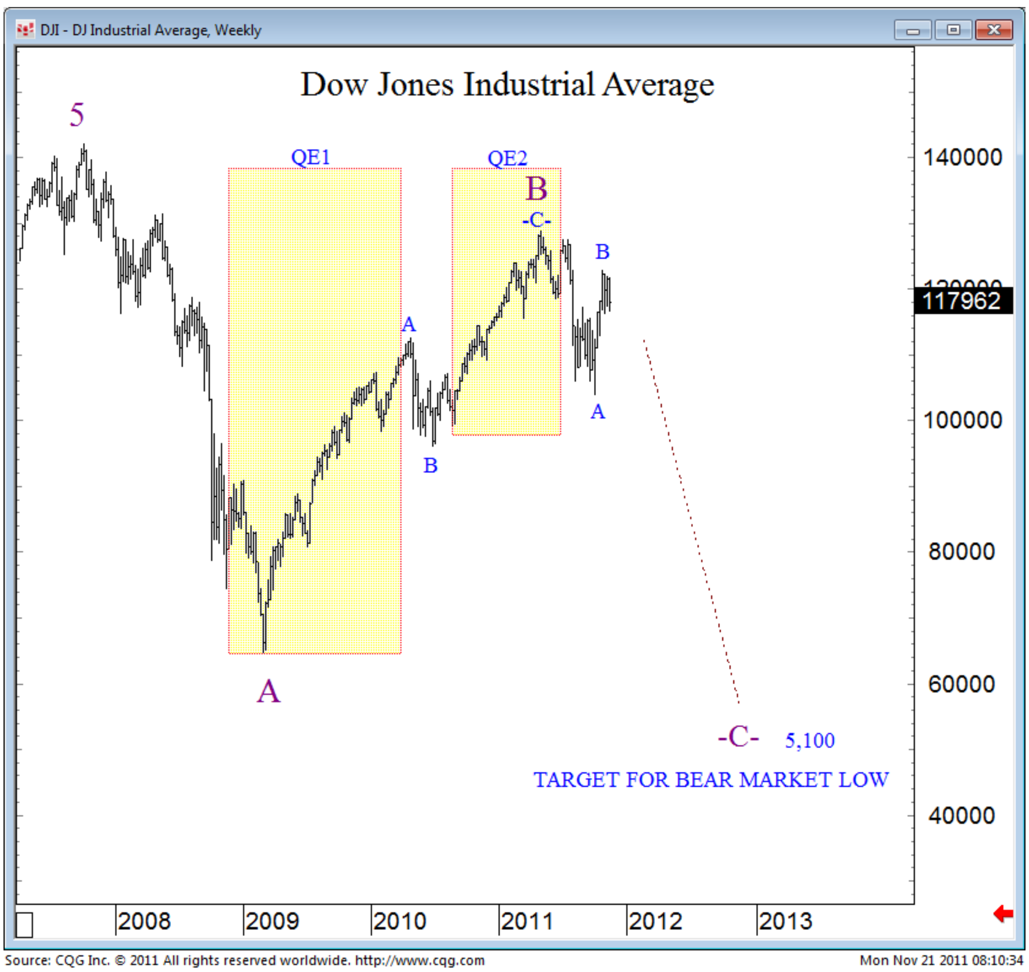
Effectively more bond buying does little to solve the long-term structural problem facing the globe. Which, more than incidentally, is the same problem that led to the credit crunch in the first place—there is too much debt in the system. Period! End of story!

So, might we see QE3 from the Fed and the ECB now that Europe’s latest “summit to end all summits” has proven a failure? Yup! If the latest budget huddle in Washington is any indication, it proves politicians do not have the will to make real changes; so why not fall back on central banks.

As I said: Gee CB pumping has worked so well before why not do it again? Otherwise we would be in a depression according to the zeitgeist (of course the Austrian School path is never given a test; it is only proven true by the grinding lower of markets that eventually wash away the dead wood).

Okay! So, we get the ECB in the game and the Fed back again "saving us." Risk assets soar for a while. Financial types would be happy, but those who live in the real economy would likely be less than over-joyed. Lest we forget at our own investment peril the real economy is where real growth takes place to support future cash flows from risk assets being bid up on happy juice.

Without real structural changes in the real economy I think the ridiculous looking wave count of the **Monthly Dow Jones Industrial Average** that has a 5,000 target painted on it starts to look a bit less ridiculous:



Word on the street is our illustrious lawyers, aka US Congress, are once again simply shuffling deck chairs on the Titanic. No doubt how that movie ended.

Happy Monday! ☺

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