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"No Exit" Cuts Both Ways

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Wednesday's shock in global markets reminds us: always a crisis, always more reflation.

Ben Bernanke must have gone to bed happy after Tuesday's FOMC meeting. Markets didn't react much one way or the other, so the ex-economics professor probably gave himself an "A" in expectations management (see "On the August FOMC" August 10, 2010). Should he reconsider now, after Wednesday's global spasm of risk aversion?

We don't see how the market could have been expecting much more from the FOMC. Indeed, the fact that the year-forward fed funds rate *fell* to new all-time lows Tuesday after the FOMC statement is some evidence that the Fed did a little *more* than the market expected. And we don't see why the Fed's wholesale downgrade of economic prospects should have spooked the market, as some have said. If anything, markets should take comfort from the fact that the Fed is cognizant of the realities of this "expansionless recovery," rather than blinding itself with wishful thinking. The gloomier the Fed feels about the economy, the more action it will take to brighten it -- that should be *good* news.

We're more inclined to focus on the unfortunate juxtaposition of events yesterday with something the Fed chose *not* to say. Tuesday's FOMC statement completely excised the following sentence, which had appeared in the June FOMC statement:

- "Financial conditions have become less supportive of economic growth on balance, largely reflecting developments abroad."

The elimination of this sentence was the one bullish change from statement to statement, and as fate would have it, it was immediately falsified by a flurry of retrograde developments in Europe yesterday:

- The new parliament of Slovakia voted to not participate in the EU's aid to Greece, reversing the government's previous commitment, and making itself the only dissenting European nation.
- Greece announced a 5.8% sequential drop in Q2 2010 real GDP (on an annual basis).
- Yields on Irish government debt rose as rumors circulated about deeper than expected problems in Irish banks, and the ECB's

Update to strategic view

US STOCKS, GOLD, US MACRO: Yesterday's spasm of risk aversion, following on the heels of the FOMC's signaling increasing ease, is the perfect picture of the "no exit" theme. We're coming out of a credit cycle, not a business cycle -- so there will be endless aftershocks, and yesterday we saw a few from Europe. At the same time, the worse the shock, and the worse the market's reaction to the shock, the more the Fed, the ECB and other government agencies around the world will do to smooth things over with reflation. In the world of "no exit," panics create buyable corrections -- but the aftershocks limit the upside. With reflation the only constant, gold remains our number one conviction trade.

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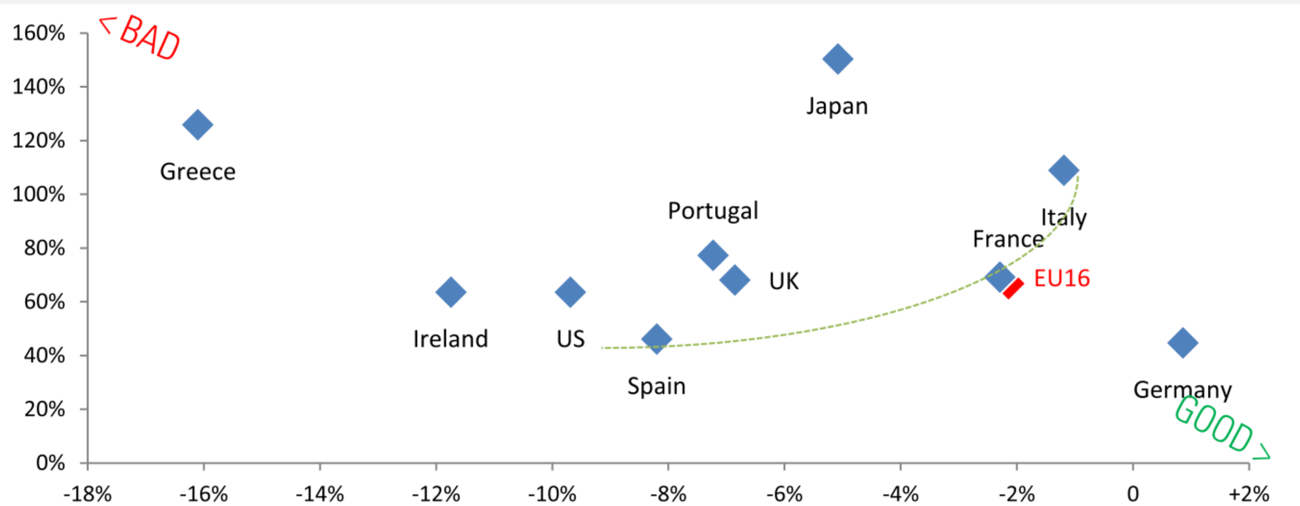
purchase of Irish bonds -- after a month of ECB bond buys tapering off to nearly zero.

- The European Central Bank announced that it had allotted $430 million to two member banks, after a month of no US dollar tenders at all.
- The German weekly *Die Zeit* reported that Eurostat is demanding that Germany consolidate into its reported federal debt the balance sheets of rescued banks WestLB AG and Hypo Real Estate. This would potentially have the effect of pushing Germany's debt-to-GDP ratio to 90%, well above the EU treaty limits, and could bear on its willingness to fund future rescues.

We've said many times that Europe's debt problems were easily solved, but only *to the extent* that the EU could conduct itself like a federal entity, which in reality it is not (see, most recently, "On the EU Bank Stress Tests" July 23, 2010). In other words, Europe *as a whole* is entirely creditworthy, even including its worst constituents such as Greece (if it's not, then the US and Japan are far worse -- please see the chart below). Slovakia's

Vertical: **Debt as fraction of GDP** Horizontal: **"Death spiral coefficient"** --- **Efficient frontier**



Source: Respective statistical bureaus, TrendMacro calculations

decision is the first breach of unanimous *de facto* federalism in EU-16 decision-making since the onset of the crisis -- perhaps trivial and only symbolic, but nevertheless freighted with the risk of broader political rupture.

We've also said that in the absence of specific rules about what events would trigger what kind of rescue, markets would likely have to probe to find out just what it takes to get German credit to really stand behind PIIGS debt (see, for example, "The Panic Abates -- But Now What?" May 27, 2010). Yesterday was a toxic combination of an incremental loss of confidence -- that probing in action -- at the same time as European federalism was thrown into question.

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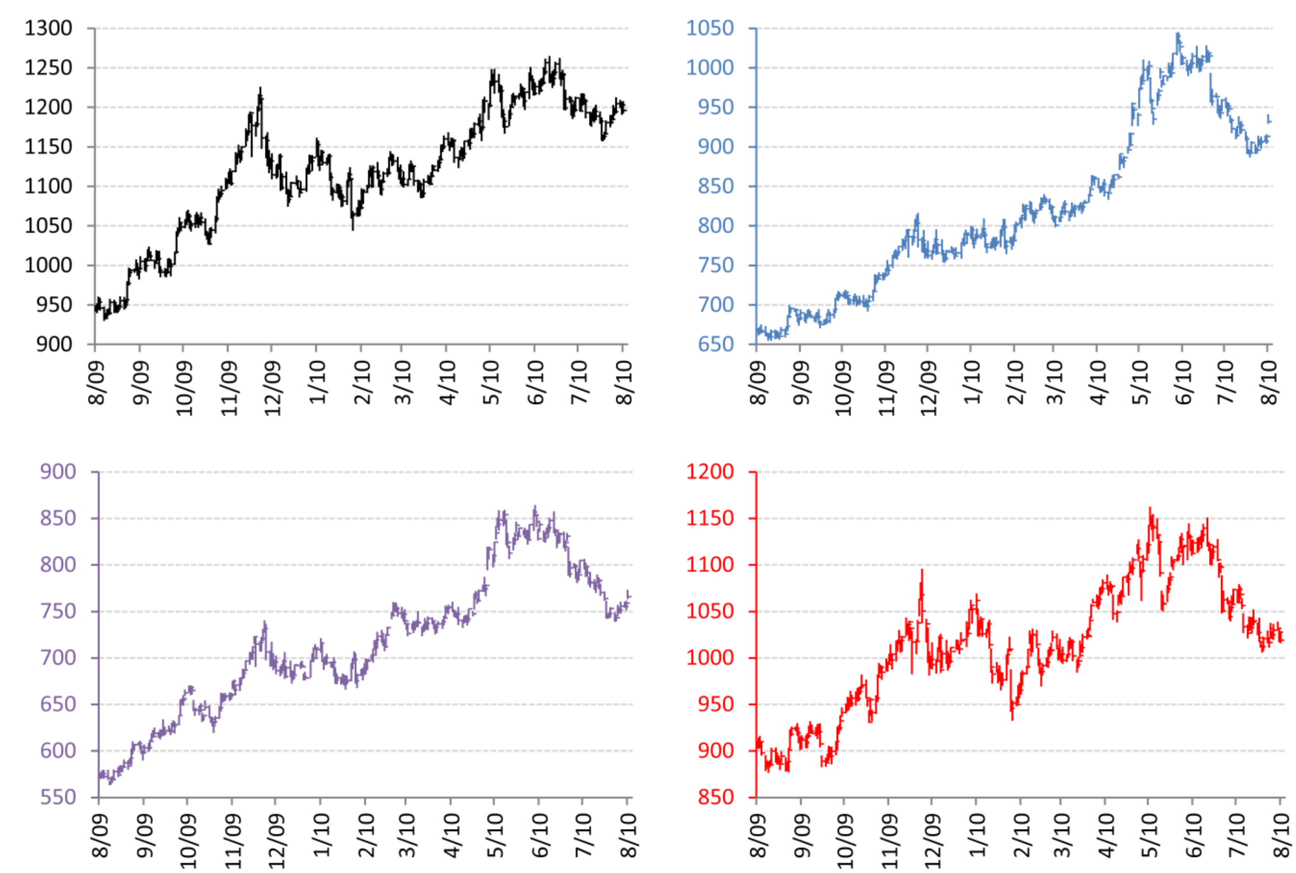
And so markets worldwide acted just like they acted through much of May when Euro-fear was at its height -- stocks down, euro down, high-grade government yields down, PIIGS yields up, euro down, dollar up, yen up. But for us, the most critical tell was gold. If this had been about the Fed not doing enough, gold would have been down as much as stocks, because an insufficiently alert Fed means a quick return to the outright deflation we saw in late 2008. But gold was higher much of the day, and closed down only a couple of ticks. That's gold acting as an alternative currency, the ultimate FX safe-haven -- not as a deflation warning (see "Gold is the Strongest Currency" May 6, 2010). To put it another way, from the perspective of a euro-based investor, gold was up 2.2% yesterday (please see the chart below). Now as of this writing this morning, gold is sharply

Gold priced in: — US dollar — Euro — GB Pound — Japan yen
At the US close, Wednesday August 11



Source: Reuters, TrendMacro calculations

higher -- up 1.6% in dollar terms, and another 2.3% in euro terms -- having gapped up on the news of a rise in US initial jobless claims, when a drop was expected. *That's* gold telling us that the worse the news get, the more reflation lies in store.

We're not especially shaken by any of this. It doesn't change anything strategically. It's par for the course coming out of a generational credit cycle, not a typical business cycle (see "So Much For The 'V'" May 21, 2010). There will be aftershocks that create panics large and small, and the game is to have the courage to buy those corrections -- *provided you continue to believe that there is "no exit" from endless measures by the Fed and others to reflate, at whatever cost to whatever currency*. We have no reason to question that, and Tuesday's FOMC only strengthens our conviction. With reflation the only certainty, gold -- the financial medium most sensitive to liquidity excess -- remains our best strategic idea.

Bottom line

Yesterday's spasm of risk aversion, following on the heels of the FOMC's signaling increasing ease, is the perfect picture of the "no exit" theme. We're coming out of a credit cycle, not a business cycle -- so there will be endless aftershocks, and yesterday we saw a few from Europe. At the same time, the worse the shock, and the worse the market's reaction to the shock, the more the Fed, the ECB and other government agencies around the world will do to smooth things over with reflation. In the world of "no exit," panics create buyable corrections -- but the aftershocks limit the upside. With reflation the only constant, gold remains our number one conviction trade.