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OBSERVATIONS ON THE MARKET

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There is a tale of a Pied Piper who played a magic flute that lured all the rats out of town into the river, where they then proceeded to drown. Sometimes it feels like we are all rats listening to the prognosticators - while the river grows ever closer... but the music of record closes sounds so sweet. Just what is that music that is playing?

There is a saying in the investment world that goes - it is not what is known that will hurt you, it is the unknown. Quantitative easing (QE3) is the 'known' right now, and it can't go on forever. The 'unknown' is guessing when it will finally end. Investors don't seem to care that it is going to end, until it appears that the end may come in the next month or so. William Poole, the former head of the St Louis branch bank of the Federal Reserve, gave a presentation in Australia recently illustrating how he expects the unwinding of QE3 to affect the economy.

His first observation was that even though the Fed has yet to act, interest rates on 10-year treasuries have moved up by over 1%. This suggests that the interest rate market is being talked higher without any action by the Fed. However, the actual impact of QE3 in the market appears to be very benign. One indication is that the growth of the money supply should have increased if injecting more money into the system was stimulating the economy. If you subtract out QE3, the money supply growth has not changed from the pre-stimulus era. Bank credit is also not growing. Just because banks have access to cheap money, they are not investing it in more loans. There is much debate as to whether the banks are unwilling to lend, or whether there isn't enough demand for loans. Poole thinks the additional banking regulations are part of the blame. There has been a fear that part of the QE3 billions have made their way into financial assets, thus creating an asset bubble. If you examine the excess reserves that are sitting on bank's balance sheets (this is money that is in addition to what a bank needs as its capital base), you see that $2.3 trillion of the $3 trillion to date of stimulus money is in excess reserves. That leaves $700 billion floating somewhere else.

Currently, the entire bond market which includes treasuries, government agencies, corporate bonds, municipal bonds, and residential and commercial mortgages total about $45 trillion. $700 billion is only 1.5% of the entire bond market, hardly a large enough number to move the market by itself. Additional proof comes in the asset that they have actually been buying. Half of the monthly $85 billion of bond purchases by the Fed have been mortgage bonds, in an effort to try and make housing more affordable. The spread between 10-year treasury bonds and 30-year fixed rate mortgages from 1976 to 2006 was 1.74%. From May 2012 to April 2013, which was the period the Fed started buying mortgage bonds (just before the market became worried about the potential end of QE3), the spread was 1.76%. You would think that if the Fed buys $40 billion per month of a bond, it would move the price more than .02%. The market is moving almost totally on news and speculation, as opposed to any actual moves by the Fed. This is significant because this is very strong evidence that once the actual taper of Fed buying begins, it will probably not effect the market as much as the market fears.

Along this same theme, the emerging markets have been complete disappoints this year. They have also been the asset class that appears to be most affected by the fear of a tapered QE3. The emerging market index has underperformed the S&P 500 by about 25% this year. It makes it the worst calendar year for relative performance since 1998. Emerging markets are trading about 30% cheaper than the S&P 500 by both earnings and book value. This divergence should reverse at some point in the near future considering that half the revenue of the S&P 500 comes from outside the US.

The market music may be seducing us to financial ruin, but it doesn't appear that the song will be the ending of QE3. It does appear that all the rats (I mean investors) that are convinced the emerging markets are headed straight for the river may also be a little premature.