AMERICAN MARKETPLACES: AT THE CROSSROADS

© Leo Haviland, 646-295-8385 October 15, 2012

"Come writers and critics
Who prophesize with your pen
And keep your eyes wide
The chance won't come again
And don't speak too soon
For the wheel's still in spin…" Bob Dylan, "The Times They Are A-Changing"

CONCLUSION

The world's long-running economic crisis of course has not limited itself to either one nation or one region. However, at its outset in 2007, most did not anticipate the scope or length of the disaster. Weren't potential risks to the international economy rather modest? Weren't issues related to the United States real estate marketplace mostly relevant only to that domain and that nation, and likely to be restricted to them? Yet substantial debt and leverage (and other intertwined issues) and their consequences were not confined either to American territory or the real estate playground.

The recent Eurozone chapters of this terrible trouble supposedly started with so-called peripheral nations such as Greece, Portugal, and Ireland. Countries such as Greece indeed first captured headlines. However, that does not demonstrate that causes of Eurozone problems necessarily started only in them. In any event, "difficulties on the periphery" engulfed the rest of Europe and traveled around the globe.

Despite broad concerns regarding worldwide economic problems and risks, despite the widespread past and current fascination with the European scene, suppose one focuses on aspects of the American stage, beginning with some highlights involving the United States alongside Canada and Mexico in the foreign exchange context. This survey of America and its geographic neighbors underlines the weakness of the United States dollar and the size of America's fiscal troubles. This suggests the merit of inquiring into US currency, stock, interest rate, and commodity marketplace past and future relationships in the context of Federal Reserve easing policies and America's fiscal problems.

The broad real trade-weighted dollar probably will continue to weaken. The dangerous United States fiscal situation probably will not be genuinely fixed in the next several months. A full-fledged threat of a federal fiscal catastrophe likely will be necessary for sufficient progress in that sphere to occur. Though the United States is not the center of the universe, the effects of further dollar feebleness and the worsening of the country's fiscal crisis will radiate worldwide.

The S+P 500 has made or soon will make a significant peak.

BORDERLINES

United States stock price levels and trends intersect with those of the US dollar, American interest rates, and commodities. And of course the US and its various marketplaces are not islands separated from others around the globe.

****

Though the economies of the United States, Canada, and Mexico intertwine, everyone knows they are not mirror images of each other. One can enlist mountains of variables to compare these nations and predict their economic paths. However, focus on a handful of them.

The real GDP, consumer prices, and current account statistics in the following table are from the International Monetary Fund's World Economic Outlook (October 2012; see Table 1.1 and the Statistical Appendix). The general government overall balance and gross debt data are for calendar years and from the IMF's Fiscal Monitor (October 2012; Statistical Tables). The numbers are in percent. The current account and general government overall balance is percent of nominal GDP, with the minus sign indicating a deficit. The general government category includes state and local governments as well as the federal one.

The table includes 2017 for medium-run forward-looking purposes. The IMF weathervane makes numerous assumptions for its forecasts, including the US federal fiscal situation. The "fiscal cliff" engages much attention and prompts widespread debate. Though much can and will occur in the complex US fiscal situation, the IMF offers a reasonable guideline (Fiscal Monitor, p71). For example, it extends the Bush tax cuts into 2013, and replaces automatic spending cuts with back-loaded consolidation measures. It assumes Congress will extend Bush tax cuts for the middle class permanently, but those for high-income taxpayers will expire from 2014. Congress regularly will adjust alternative minimum tax parameters and Medicare payments.

****

	Real GDP				Inflation (Consumer Prices)			
	2011	2012	2013	2017	2011	2012	2013	2017
USA	1.8	2.2	2.1	3.3	3.1	2.0	1.8	2.1
Canada	2.4	1.9	2.0	2.3	2.9	1.8	2.0	2.0
Mexico	3.9	3.8	3.5	3.3	3.4	4.0	3.5	3.0

	Current Account			
	2011	2012	2013	2017
USA	-3.1	-3.1	-3.1	-3.5
Canada	-2.8	-3.4	-3.7	-3.0
Mexico	-1.0	-.9	-1.1	-1.1

	General Government Overall Fiscal Balance				General Government Gross Debt			
	2011	2012	2013	2017	2011	2012	2013	2017
USA	-10.1	-8.7	-7.3	-4.4	102.9	107.2	111.7	114.0
Canada	-4.4	-3.8	-3.0	-.7	85.4	87.5	87.8	78.1
Mexico	-3.4	-2.4	-2.1	-2.0	43.8	43.1	43.2	42.9

****

What stands out? The fiscal landscape of the United States is far worse now and for the near and medium term (out to 2017) than that of Canada and Mexico. Despite some progress by America in reducing budget deficits, 2013's remains substantial and 2017's -4.4 percent is not trivial. Thus the United States not only makes no progress in slashing its gross debt, it increases. In contrast, Canada's gross debt slides lower from 2013 to 2017, and Mexico's remains well underneath that of America and Canada. What was general government gross debt back at the close of the blissful Goldilocks Era? Canada's was 66.5pc in 2007, about that of America's 67.2pc. Mexico's was 37.6pc in 2007. Thus America's situation has worsened far more significantly from this perspective.

The growth and inflation numbers across the nations do not differ remarkably. However, recall the Federal Reserve's unwavering determination to pin Federal Funds rates near the ground. With US inflation around two percent, this yield repression now makes for a negative real return across several years of the government yield curve. Continuing this "help the debtors (borrowers)" policy into 2013 and thereafter is unlikely to please creditor (lenders). Also, America continues to run a substantial current account deficit. Foreigners possess much of the publicly held US federal debt. This vista displays bearish risks for both the broad real trade-weighted dollar and the US fiscal arena.

IN THE CURRENCY CORNER

Within the US broad real trade-weighted dollar ("TWD"; Federal Reserve Board, H.10), the Canadian dollar ("CD") and Mexican peso ("MP") possess substantial shares. Consequently United States dollar ("USD") cross rates against Canada and Mexico are quite important for TWD levels and trends. Canada currently holds about 12.9 percent (15.2pc in 2007, 16.9pc in 2000), Mexico just under 11.3pc (9.7pc in 2007, 10.3pc in 2000), for a combined total of 24.2pc. This is not much change from 2007's 24.9pc, though it falls modestly relative to 2000's 27.2pc. China currently represents nearly 20.4pc of the TWD (a dramatic rise from 7.9pc in 2000), with the Euro FX 16.5pc (17.3pc in 2000), the British Pound 3.4pc (5.5pc a dozen years ago), and Japan 7.3pc (sharply down from 2000's 12.8pc).

Measures of effective (trade-weighted) exchange rates can vary. In any event, the cross rates for the CD and MP against the US dollar are even more important for broad measures of their currencies. Note the Bank of Canada's Canadian dollar effective exchange rate index ("CERI") for its six major trading partners. In this, the US dollar, with its 76.2pc weight, plays a far greater role than does the Canadian dollar in the Fed's broad real TWD index. In CERI, the MP has 3.2pc, Euro FX 9.3pc, Japanese Yen 5.3pc, and Chinese renminbi 3.3pc.

The US dollar also plays a major part in Mexico's currency relationships. Within the Bank for International Settlements' ("BIS") broad effective exchange rate measure for Mexico, the US share is 53.1pc. Canada's 4.1pc piece is much smaller (Euro area has 9.3pc, China 13.0pc). Based upon the BIS measure (which includes more nations than CERI), the US share of Canada's, at 58.4pc, is not much different from its 53.1pc section of Mexico's.

****

Since its February 2002 pinnacle around 112.2 (monthly average; March 1973=100), despite notable bull moves, the TWD generally has declined. It reached a low around 84.2 in April 2008 during the early stages of the international economic disaster, thus grazing the prior historic floors near 84.0 (October 1978's 84.1, July 1995 at 84.0). Although it rallied to 96.9 in March 2009, it resumed its mournful slump, sharply falling to 87.1 in April 2010. After a minor jump up to June

2010’s 89.7, it retreated further. By July 2011, the once-mighty TWD tumbled to a new record bottom, at 80.6 in July 2011. Though it edged up to reach 86.2 in June 2012, it slipped under 84.0 in September 2012, averaging 83.8.

The Canadian dollar and Mexican peso cross rates against the dollar do not necessarily move in the same way against the USD. But they have tended to do so over the past several years. For example, note the roughly similar timing lows they made against the greenback. The CD bottomed 3/9/09 at 1.3065, as did the MP at 15.59. Recall the major low in the stock marketplace benchmark, the S+P 500, on 3/6/09 at 667. Note an intermediate bottom in the CD at 1.1725 versus the USD on 7/8/09 alongside the MP’s 13.85 one on 7/9/09. In mid-2010, see the important CD valley of the 5/25/10 (1.0853) and 8/31 (1.0673) lows; the MP likewise established them on those days (13.38 and 13.27).

What about 2011 and 2012? The CD’s important lows against the USD were 10/4/11 at 1.0658 (key S+P 500 bottom that day at 1075) and 11/25/11 at 1.0524. The MP’s early fall 2011 weakness paralleled that in the CD; remember the 9/23/11 low at 14.14 and the 10/4/11 one at 14.10 (recall the 10/4/11 low in the S+P 500 at 1075). Its 11/25/11 bottom at 14.31 was the same day as the Canadian’s. Both made important lows in June 2012, the MP on 6/1/12 at 14.60, the CD a few days later, at 1.0447 on 6/4/12. The S+P 500 achieved an important bottom at almost exactly that time, on 6/14/12 near 1267.

****

In addition to CD and MP cross rate trends versus the dollar, one should monitor their effective exchange rate ones. Important levels and trends for the CD and MP effective exchange rates intertwine with and influence marketplace decision-making and thereby their cross rates against the US dollar. After all, the USD is a major part of their effective exchange rate.

The Bank of Canada’s Canadian Dollar effective exchange rate index (CERI) for September 2012 is 122.3. This borders key highs. Note July 2011’s 123.8 (123.7 in April 2011), which was adjacent to the November 2007 summit at 123.9. Thus a march above 124.0 would be very significant for the Canadian Dollar. The 124.0 level represents a huge rally, 28.2-percent, from the 96.7 bottom of March 2009.

Also monitor a Canadian Dollar’s effective exchange rate index devised by the Bank of England (1990=100, monthly average). After touching a low in 4Q11 around 109.4, this CD index mounted to 115.0 in September 2012. Important resistance hovers around 117.0. Recall not only the highs of April 2011’s 116.7 and July 2011’s 116.8, but also the critical November 2007 pinnacle at 117.2.

A key bottom in the Bank of England’s Canadian Dollar index was October 2002’s 75.4 (alongside the January 2002 low of 75.6). A low for the CERI was about 79.8 in January 2002. Recall the TWD’s February 2002 peak.

What does the BIS’s broad (CPI based) real effective Mexican peso exchange rate reveal (monthly averages; 2010=100; data from 1994 to present)?

The April 2011 high in the real Mexican peso was 104.6. It fell to about 91.3 in November 2011, which June 2012 matched. However, note its modest rally since June 2012, with September 2012 at 96.7. A five percent rally from 91.3 is 95.9, a 10pc one gives 100.4.

What about some longer run history? The Mexican peso crisis occurred end 1994/1995 (devaluation 12/20/94). The BIS Mexican peso index's record low was about 62.4 in March 1995, a fifty percent rally from that is 93.6. Its extreme height was March 2002's 133.2. Other key highs arrived in February and December 2006 (115.9/115.6) and August 2008 (113.8). As the worldwide financial disaster that emerged in 2007 worsened, the BIS peso index crashed to 87.5 in February 2009.

CROSSING THE CURRENCY BORDER

Currency marketplaces are not isolated from interest rates, equities, and commodities. So why not quickly walk back and forth across parts of these domains to generate additional perspectives on them?

****

The extremely accommodative monetary strategy of the US Federal Reserve is a key factor linking to the depreciation of the broad real trade-weighted dollar (TWD) since its March 2009 high. Though other factors than Fed policy influence cross trends against the Canadian dollar and Mexican peso (think of commodity prices for the CD), the Fed's easing regime also has encouraged weakness in the USD crosses against the CD and MP. Not only has the Fed shoved policy interest rates to the ground floor for the past few years. The ever-vigilant central bank recently proclaimed (9/13/12) that Federal Funds likely will stay around there through mid-2015. In addition, underline the Fed's money printing festival. Following two rounds of quantitative easing and the Operation Twist scheme, on 9/13/12 it embarked on a third money printing adventure.

****

The doctrine of "strong US dollar equals weak US stocks (S+P 500), weak US dollar equals strong US stocks)" has inspired and guided many marketplace players for several years.

Although the Fed does not publish daily data for the broad real TWD, it does for the nominal TWD. The nominal TWD established a high on 6/1/12 around 103.0, drifting lower from there and 7/25/12's 102.33 (note the lows in the US Treasury 10 year note on 6/1/12 at 1.44 percent and 7/25/12 at 1.38pc). After 9/13/12's close just under 99.19, the nominal TWD has moved sideways (9/14 low 98.34, 9/26 high 99.19; as of early morning of 10/15/12, there is no data posted after 10/5/12's 98.45).

What has occurred in the CD and MP cross rates relative to the USD in the few weeks since the Fed's 9/13/12 announcement of its latest round of money easing? Not much. Like the nominal TWD (and therefore probably the broad real TWD), they basically have moved sideways. The Canadian Dollar has weakened slightly, slipping from its high of .9633 on 9/14/12 to around .9800 at last week's close. The MP has swung sideways. Its 9/14/12 high was 12.71, its 10/5 one 12.66; its low since 9/13/12 is 9/20's 12.95, and it was around 12.85 at the end of last week.

****

Admittedly little time has passed since 9/13/12 and the Fed's glorious unveiling of QE3 and its joyous promise of low rates into mid-2015. The S+P 500 majestically climbed after the Fed's previous two generous money printing rounds. And stocks eventually advanced after Operation Twist in autumn 2011 as well (recall the European Central Bank's very Long-Term Refinancing Operations/LTRO programs of late December 2011 and 1Q12 in light of that climb).

However, since 9/13/12, the S+P 500 only briefly marched higher. On 9/14/12, it achieved a new peak at about 1475 for the bull move that began at the March 2009 abyss. It since has dipped (10/5/12 high 1471), although only modestly, closing near 1429 on 10/12/12. And note the Fed's 9/13/12 accommodative announcements closely coincided with the ECB's 9/6/12 Outright Monetary Transactions/OMT easing.

Based on rules of thumb for the recent past, shouldn't all this fervent Federal Reserve easing be resulting in stronger stocks and a feebler dollar? But it hasn't. Since the Fed unveiling of QE3, the slightly down move in the S+P 500 confronts relative TWD peacefulness. A scan of key USD cross rates fits this sideways TWD pattern. Since mid-September, the CD is slightly weaker, the MP on balance sideways. The Euro FX likewise is about unchanged. It closed 9/13/12 at 1.2991. Though it rallied to a high of 1.3130 on 9/14, it closed 10/12 at 1.2951. The Chinese renminbi, however, has advanced against the USD; the cross closed around 6.3300 on 9/13 and 6.2658 on 10/12.

Moreover, it is very significant that the modest drop in the S+P 500 since the Fed easing has not been matched by a rally in the US dollar. Though not much time has passed since mid-September, this hints that further falls in the S+P 500 may not be joined by a dollar rally. Keep in mind the long run TWD bear move since February 2002's 112.8 (and March 2009's 96.9) and its renewed weakness since June 2012's 86.2.

****

So what's happening with stocks? Shouldn't the S+P 500 be rallying and making higher and higher highs as it did in the past? The S+P 500's inability to advance after the Fed's (and ECB's) latest easing festivals strongly hints that it has reached a crossroads.

What's the bottom line for stocks? The S+P 500 probably has made or soon will make a noteworthy peak. That would be consistent with America's grave current and near term fiscal problem (and the looming long run US deficit disaster) as well as the overall ongoing international economic crisis. Given the association of US stock bull trends with the global recovery, a sharp decline in the S+P 500 would be an ominous sign for the international scene.

****

Of course US current and anticipated corporate earnings influence equity prices. But recent corporate earnings do not show signs of rising. What if America's capital gain and dividend tax rates jump?

****

Influenced by their perspectives on the trading history of the past several years, many are married to the view that a significant S+P 500 decline will involve a decline in yields of US government interest rate benchmarks such as the 10 year US Treasury note (flight to quality). However, this pattern probably will begin to transform fairly soon. This change means that higher UST yields will coincide with falling US stocks.

****

In recent years, rising yields in the US Treasury 10 year note roughly have coincided with rallies in the S+P 500 and some economic recovery- and with revelations and implementations of the Fed's QE1 and QE2 money printing and Operation Twist related easing policies. Recall the yield lows of 12/18/08 (2.04pc)/3/18/09 (2.47pc), 10/8/10 (2.33pc), and 9/23/11 (1.67pc). Declining yields approximately have fit slumps in the S+P 500. Note in this regard the ending of QE1 in

March 2010 and QE2 at end June 2011. Rising rates since the 6/1/12 and 7/25/12 lows fit the pattern of an equity rally; the S+P 500 made an important low on 6/4/12 at 1267.

The UST 10 year's recent high at 1.89pc was on 9/14/12, the same day as the S+P 500's summit in its bull marketplace campaign beginning in March 2009. The slight decline in yields since then (10/12/12 close around 1.65pc) is consistent with the modest fall in the S+P 500.

However, that fall in the 10 year's yield since 9/14/12, like the decline in the S+P 500, is not consistent with the QE1, QE2, and Operation Twist period experience. Maybe that consistency will return; after all, only one month has passed since the blessed revelation of QE3.

However, this trend involving stocks and the UST note since mid-September 2012, when interpreted alongside a worsening US fiscal situation and previous marketplace responses to Fed money printing (and Operation Twist), warns that the past relationship between government yields and the S+P 500 has commenced or soon will begin the process of changing. The failure of the TWD to rally much since 9/14/12 as stocks declined- and particularly in light of the dollar's weakening since June 2012- suggests this as well.

****

In this context, let's drift into the commodities domain. Many marketplace watchers have noted that for the past several years, bull moves in commodities "in general" have roughly tracked those in the S+P 500. Very significant bottoms have occurred around roughly the same time (within several weeks). The same has been true of bear ones.

The fall in commodities despite the recent round of Fed easing confirms the Fed's increasingly inability to rally US equities. The broad GSCI warns that a top in the S+P 500 is in place (9/14/12) or will be so relatively soon. The broad GSCI minor top around 699 on 9/14/12 occurred the same day as the S+P 500 high. As for the S+P 500, the broad GSCI has ebbed lower, with its 10/12/12 close around 665. In addition, the broad GSCI 9/14/11 top around 699 rests well beneath the 4/11/11 and 5/2/11 tops at 762 as well as the 3/1/12 plateau around 718).

****

The weaker dollar since June 2012 (and its failure to rally since 9/14/12 as the S+P 500 moved down) fits a story of declining faith in American creditworthiness and the nation's (and the world's) ability to maintain a robust economic recovery. UST yields fell after 9/14/12 (still fitting its pattern when stocks fall), but this yield drop (and pattern) probably will not continue if fears grow significantly regarding the American fiscal situation. Recent statements from the International Monetary Fund give signs of these growing worries.

Assuming that the American fiscal disaster plays a key role in a US equity marketplace downturn, US government rates will ascend. Inflation is not the only source of American rate rises (and the Federal Reserve is determined to create and sustain inflation at or around two percent). So are substantial concerns about America's creditworthiness. After all, the US will seem like less of a quality place to put money. Recall the recent history of rates on the European periphery, as well as debt and yield chronicles of many emerging marketplaces (or the fate of many corporate junk bonds). How happy are foreign holders of US Treasury obligations at current low yields?

The valiant effort by the Fed to keep rates low to some extent can restrict interest rate rises. However, since nominal (and real) UST returns are low, and when existing concerns about US credit quality grow significantly, that Fed policy nevertheless risks further weakening of the broad real trade-weighted dollar. Suppose a significant bear move occurs in the S+P 500. Such a

S+P 500 fall probably will connect with US dollar weakness and a challenge to and break of the July 2011 TWD bottom.

****

According to the International Monetary Fund's World Economic Outlook (chapter 1, p13; October 2012), "Risks for a Serious Global Slowdown Are Alarmingly High". In the WEO Annex (p173), the IMF Executive Board remarks: "The United States and Japan, in particular, urgently need to adopt credible medium-term adjustment plans to reduce their debt to sustainable levels." See also the IMF's Global Financial Stability Report (Executive Summary, p xi; October 2012); the United States and Japan "continue to face significant fiscal challenges, as assessed in Chapter 2."

Olivier Blanchard, Economic Counsellor and Chief Economist of the IMF Research Department, said: "You use the word fiscal expansion. I think that there are very few advanced economies in which I would be willing to entertain the thought." Though he did not specifically mention the United States or other nations, he underscored: "We are facing a very difficult situation in which the levels of debt are very high. These are levels of debt where things can go wrong very, very quickly. If investors start having doubts, they ask for high interest rates, which leads to an enormous interest burden which increases the risk that something wrong happens, which justifies in turn the interest rate. We are in a zone where we really don't want to stay. Can we really increase the level of debt, have further fiscal expansion? I don't think that is a possibility. The question is at what speed we should consolidate…unless you are under tremendous pressure from markets and cannot convince them to go more slowly, you should do it steadily, but slowly." ("Transcript of the World Economic Outlook Press Conference", 10/9/12).

****

Thus the emerging (current) story and trend appears to be: weaker dollar (TWD), weaker S+P 500, and higher government rates (UST 10 year benchmark). This vision admittedly is dramatically different from the current popular faith in these marketplace relationships.

****

A sustained move of the UST yield over its 9/14/12 high at 1.89 percent alongside some further S+P 500 weakness would tend to confirm this viewpoint regarding marketplace interrelations. An advance above two percent (12/18/08 bottom at 2.04pc) coupled with a S+P 500 tumble would emphasize it. Maybe it would take a move in the UST above the 2.35/2.50pc range bound up with an equity fall to significantly spread faith in the higher government yields alongside weak stocks scenario. Why 2.35 to 2.50pc? The 2.47 percent low on 3/18/09 was not long after the major low in the S+P 500. Also recall not only the 2.33pc low on 10/8/10 (S+P 500 final key low 8/27/10 at 1040), but also the tops of 10/28/12 at 2.42pc and 3/20/12 at 2.40pc.

****

Price, time, and distance indicators for the S+P 500 are consistent with an outlook that the S+P 500 has attained a notable peak, or will soon do so. One should review S+P 500 levels and trends alongside those of other international stock marketplaces.

The S+P 500's 5/19/08 at 1440 was the key final high after the major peak at 1576 on 10/11/07. The 9/14/12 high around 1475 is close to that 1440 peak, exceeding it by only 2.4 percent. Watch the 1440/1400 range. A 33pc rally from the important 10/4/11 at 1075 is about 1433. The 4/2/12 high was 1422 (1415 on 5/3); a five percent dip from 1475 is about 1400; a 10pc fall from 1576 equals 1418.

The rally from the key low on 10/4/11 near 1075 to the 9/14/12 ("around October") peak is almost exactly one year (and one could extend the current high date to include the 10/5/12 top at 1471), a bearish indication from the time dimension. Also, the 9/14/12 height is about five years from the 2007 peak, a related warning signal to stock marketplace watchers. Other major S+P 500 trend changes in addition to the 10/11/07 peak have occurred in calendar October. Recall the 10/4/74 low at 61, the 10/20/87 bottom at 217, and the 10/10/02 valley at about 769.

The 9/14/12 height is about 2.21 times the major low price of 3/6/09. This is a big move over a rather long period of time. Compare the bull move to the 1576 pinnacle on 10/11/07 relative to its lows. Dividing it by the major low on 10/10/02 gives about 2.05; dividing it by the final low around 789 on 3/12/03 gives 1.99. Thus the 2009 and 2002/03 bull moves traveled about the same distance, even though the rally from the 2002/03 depth was longer in duration. Also, March was start date for both the 2009 rally and the final bottom in 2003.

****