

12 April 2015

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Discussions are always plentiful about “how unusual the times we live in are.” However, the times we live in regarding monetary policy, tools and practices of the American Federal Reserve are centuries old. Central Bank heads of present and past have stimulus spending and monetary tightening. Energy policies which closely regulate the sale of oil also can be effectively applied to enhance or soften a desired economic outcome. We live in a free market economy, so in order to shape economic outcomes, governments in democratic societies intercede by incenting or deterring certain behaviour such as the tax breaks on buying electric cars, solar energy and more recently in America, the exploration and extraction of oil and gas.

Let's go back to the 1987 market crash and look at a sample of near economic history and how monetary policy was applied along with the effects oil on markets. Excessive monetary tightening lead to the market crash. Oil huge price decline pushed P/E (price/earnings) ratio from 13 times to over 20 times. It also did not help the year before in 1986, the American Federal Reserve kicked in stimulus spending to incent economic growth. Stimulus spending was reapplied in 1988 tapering gradually with a complete fade out in 1990. A measured and systematic approach to stimulus spending set up the 1990's as the decade of economic exuberance. As a method of slowing economic growth and avoiding an overheated economy and market, the supply of money tightened and the cost of borrowing started to rise August 1994. As the desired effects took hold and the economy cooled, interest rates were lowered again in 1996 lasting till 1999. The American Federal Reserve bank started tightening the money supply and raising rates in June 1999 which lead to interest rates rising to record levels in January 2000.

All central banks use the process of lowering interest rates, raising interest rates and increasing or decreasing the supply of money to either to make markets liquid during a recession or periods of contraction.

Since the practice of quantitative and qualitative easing have been in play not just in recent history but even in Roman times, why do equity markets get jittery each time central banks make announcements. Well the answer is also evident in historical data. Central bankers historically have been too liberal with money supply and then dramatically rush to raise interest rates and tighten money supply almost over night as took place in 1987.

So far the American Federal Reserve has got it right by not applying knee jerk behaviour in monetary and fiscal policy. Interest rate increases or decreases have been consistent with the underlying economic climate not just in America but globally.

Will the American Federal Reserve raise interest rates anytime soon? Not likely, a rise in interest rates in America would fuel the American dollar to increase, making exports of American goods very costly abroad. Secondly, the American dollar has appreciated by over 20% in such a short period of time, allowing American corporations to buy raw material and supplies at a discount as compared to non American corporations, which directly feeds the bottom line as Americans themselves are the largest consumer of goods and services in the world. The appreciation in the dollar and America's strengthening economy itself put the dollar in a safe haven zone, further reducing the need for higher interest rates to attract foreign investment.

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Lastly two overwhelming factors which play directly into future strength of the American dollar and future interest rates are:

One: the mass printing (devaluation) of global currencies such as the Euro dollar, the Japanese Yen, the Chinese Yuan and both the Canadian and Australian dollar. Canada and Australia have not needed to print money but have eased their currencies and cut central bank interest rates.

Two: America has gone from being an oil consuming nation to soon becoming the number one exporter of oil. The very dependence on oil historically has been a weak spot for the world's super power as it was always vulnerable to energy pricing shocks, oil embargoes and geopolitical instability. Now, what happens around the world and in the Middle East does not send oil prices sky rocketing since the amounts of oil extracted in North America can not exceed the demands of the entire continent. America can however flood world markets with cheap oil and natural gas. I suspect the value of American dollar is already influenced by petroleum and will behave like a petro currency into the future.

America has solved its biggest problem since WWI both on a national security front and economic expansion. Cheap energy that can flow uninterrupted, not dependent on external supply and more importantly, the dollars generated go back to American coffers not to foreign dictators who ultimately plot against them.

The future is here! America not only controls its energy supply, it has with in its reach the control and influence of the global price of oil and energy which was never attainable before. No other nation has such combined strengths. It has the largest consumer base in the world. The dollar is the life blood of all global commerce which is why all materials, goods and services around the world are priced in USD. Oh yes, the last and most important ingredient.... cheap and uninterrupted supply of oil and gas (energy).

As global economies struggle to move forward in a world full of unrest and economic turbulence, I see America as the only economy set to move forward and grow GDP without much restraint, except for the lack of bipartisanship. Canada will be a winner from the very fact we are the largest trading partner to America and our economic house is in good order. The rest of the developed and developing world would love to be in our shoes.

A North American centric strategy is the most effective I believe. Why? The ECB and the Euro zone are about 4 years behind the Americans regarding executing all the necessary monetary and fiscal reforms to ensure economic stability. The lack of cohesive unity in the Euro zone is another headwind that will hamper economic growth. The cheap and uninterrupted supply of oil is another issue troubling European growth. Currently, the EU as a whole is at the mercy of Russia. President Vladimir Putin has and will continue to use Russia's geographic position to exert both economic and political pressure on the old continent with Germany bearing the brunt. Fortunately, EU corporations are very lean and progressive business entities. However, the flow of investment dollars back to America along with the repatriation of capital seems to indicate capital is flowing away from Europe.

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China is in the throes of the largest anti corruption campaign since Mao. Crack downs are at all levels of government which has seen an outflow of capital by wealthy families and businesses. To ease the economic slow down and prop up the real estate market, China's leadership is easing lending specific only to ownership of first and second residences but not business lending. China depends heavily on real estate to grow which has come to near collapse, with some cities stopping development all together. Tension in Hong Kong only weakens economic growth and the reinvestment of capital. The economic recovery will not be brisk as most analysts had hoped for. In order to make the next big leap into the world stage both economically and politically major monetary and fiscal policies must be enacted hence why we are seeing the crack down and clean up of corruption.

Here in Canada, we are nearing a federal election. Our Loonie is able to stay with in the 80 cent mark and Ontario's manufacturing sector is firing up steadily. At all levels of government across the province we are seeing heavy spending on infrastructure programs and job creation. Infrastructure spending is usually followed by capital reinvestment by the corporations.

Interest rates in Canada look to hold or decline by 0.25% in the months ahead as western Canada is still very fragile and under great pressure as oil prices have hit bottom. A key factor as to how soon interest rates will change in Canada depends on how quickly the American Federal Reserve looks to raise rates. Janet Yellen the chair of the Federal Reserve has signaled she is in no great hurry to increase rates.