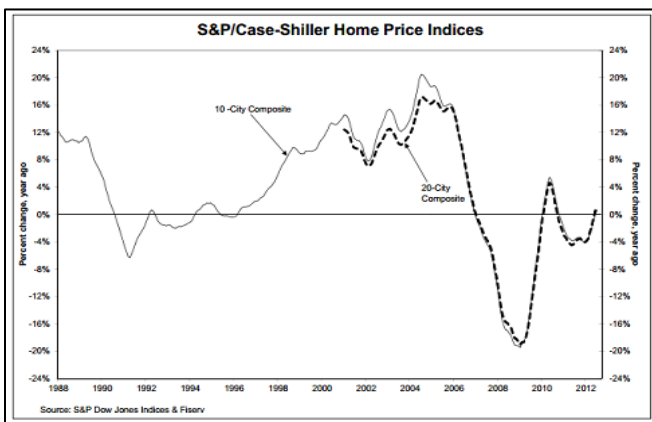


September was another positive month for share prices as the two “Fairy Godmothers” Ben and Mario gave the markets what they wanted. Each has dipped into their purses and are promising that they will buy bonds in the markets. The ECB will buy short dated high yield bonds of “problem” economies such as Spain, whilst the US Federal Reserve Bank will purchase not government debt but bonds backed by household mortgages in a targeted move to get the US housing market moving. At the moment these are just promises, Godmother Ben can and will deliver on his, Mario Draghi would like to be able to do the same but Europe doesn’t operate in that way. So far the Germans are supportive and the belief is that this plan is legally valid, but until the buying actually starts there will always be an element of doubt. However, as time moves on, each of the major concerns that have worried markets are gradually being ticked off one by one.

### USA QE3

It would be impossible to underestimate the significance of Ben Bernanke’s recent QE3 announcement. Since 2009 economists have been torn between fears of inflation and fears of deflation i.e. those that believe QE will unleash 1970s style inflation and those that point to Japan and say that deflation is the real enemy. Japan has spent over ten years stuck in neutral. It has taken an earthquake, tsunami and nuclear meltdown for this stagnant economy to begin to grow again.

The Fed has been careful to play both sides of the argument. Providing some stimulus, then hanging back and seeing what happens, being reticent to do too much just in case it inadvertently unleashes the inflation genie out of the bottle. But with minimal and slowing growth, a flat housing market, limited jobs growth plus the pressure from an incumbent President facing re-election they have given up playing both sides and have gone “all-in”. The Fed is now firmly in the deflation camp, China’s current stimulus programme has come too late for Obama, he has to rely solely on the Fed. Ben Bernanke has therefore taken his cue from the ECB’s Mario Draghi and stated that he will do whatever it takes for as long as it takes to ensure that the USA does not become Japan. He is doing this by specifically targeting the US housing market.

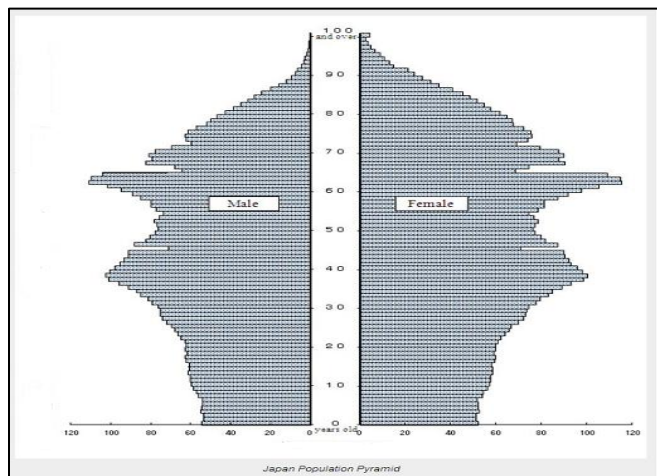


The Fed might just be pushing on an open door. US house prices have stopped going down and are just beginning to grow again. Consumers feel more relaxed about spending when they can see their biggest asset growing in value. Remortgaging for many Americans becomes an option once house prices climb closer to their original mortgage valuation. Many are in negative equity and don’t want to hand their home back to the bank. Rising house prices could be transformational for the US economy just as it would over here. Once house values increase so will consumer spending.

So what exactly is the Fed doing? Firstly, they are buying Mortgage-Backed Securities at a rate of \$40 billion worth a month. Unlike QE1 and 2, which were for a fixed period, this plan is open ended, it is for as long as it takes which is very significant. Another key point is that it is targeted on one sector i.e. housing. Previous QE (and this is still the case in the UK) has been aimed at keeping the Banks alive and not directly stimulating the economy and thus inflation. QE keeps money market rates low and allows the banks to fund their cash flow. This is great for the banks but if they do not lend this cash out it has minimal impact on the economy. In the US the Fed has had enough of this and by targeting house related loans will allow the banks to recycle their mortgage books, thus initiate new lending. The banks now know that whatever they lend they can offload the risk to the US Government. This should for US homeowners make getting a new mortgage or re-mortgaging easier and at lower rates of interest. The Fed will also continue with

its existing activities known as Operation Twist. There is still the danger that this won't be enough, QE didn't work in Japan, is clearly not working in the UK and the Europeans haven't even started it yet. But the odds do favour the Fed, firstly timing, they are stimulating mortgage lending just as US House prices are beginning to show some signs of life, whilst the Japanese issues may be of a more fundamental nature that no amount of QE can help.

## Japan Population Pyramid



One of the problems that Central Bankers and economists have is trying to translate the experience of one economy to another. We have written before of the dramatic economic growth of those countries with large populations growing rapidly from low levels. Japan has a large population, 126million, but one that is shrinking. So for the economy as a whole to grow individual wealth has to increase at a rate greater than decline in population, very hard to do. Over the next 25 years Japan's population is forecast to fall by 12 million, meanwhile India's will grow by 400million, the USA by 70million and somewhat worryingly for road traffic, the UK by 10million. So to use Japan as an example where QE won't work is dangerous.

## Spain

Spanish banks lent money badly, lots of property development loans for large projects that relied on Northern Europeans retiring to the sun. The Credit Crunch killed that market and the banks stuck their head in the sand and hoped that the problem would go away. It hasn't, there are officially €60billion of bad loans in Spanish Banks which now need bailing out. Spain can't afford it and the EU/ECB is offering it a lifeline. The Spanish though want to check the numbers first; can they cope without the EU's money and without the austerity restrictions that come with it? Markets believe they can't and it is only a matter of time, but in the meantime we have another soap opera drama to make markets nervous. There is an intriguing twist though; Catalonia is sensing an opportunity for independence. At the moment this is the Province not the whole historic geographic state but could we be seeing the beginnings of a break up of Spain?

## Markets

Despite all the gloom and news from Europe equity markets continue to make progress in 2012. With year to date the average equity unit trust up around 8%, and Bonds are still making progress as well, up by 2.5%. The fundamentals remain unchanged, Central Banks are in stimulation mode and share valuations are cheap, a recipe for continued equity outperformance. As ever we have hurdles to overcome, Europe is improving but at a glacial pace. Spain will be in focus this quarter as will the big event of the year the US Presidential election. Furthermore Iran/Israel remains in the background plus we are also due for another Greek crisis at some stage.

October is often the trickiest month of the year whilst November and December are amongst the best. Equity markets like adages and "don't fight the Fed" is particularly apt for now. Traders will be scared of selling markets that the Fed is stimulating. The USA is not Japan; it can turn itself around and will grow again. Time is short for Obama but with the Fed on its side the outlook for stock markets remains positive.

**September 2012**

This information is not intended to be personal financial advice and is for general information only. Past performance is not a reliable indicator of future results.