NEW MINERVA REPORT

Conundrum

In February Alan Greenspan gave his half yearly Policy Report to Congress. This gives us a useful insight into what is on the Federal Reserve's mind, as it shapes its policy. It also gives us an insight into what is uppermost in politicians' minds. They quiz the Fed Chairman after he has given his testimony. The following paragraph from the Testimony best sums up the Fed's overall views of the economy and markets: "*All told, the economy seems to have entered 2005 expanding at a reasonably good pace, with inflation and inflation expectations well anchored. On the whole, financial markets appear to share this view. In particular, a broad array of financial indicators convey a pervasive sense of confidence among investors, and an associated greater willingness to bear risk than is yet evident among business managers.*"

However, there were areas of concern that could be found in the Fed's report when you start to scratch below the surface of Greenspan's polished and diplomatic responses. The first ones of these were summed up in the sentence: "*For the moment, the broadly unanticipated behaviour of world bond markets remains a conundrum.*" This related to the fact that, as the Fed was raising short term interest rates, longer rates were actually falling in level. Although Greenspan didn't actually say so, the lower longer rates were undoing the effects that the Fed desired from raising short term rates. Greenspan re-iterated a number of reasons why he thought that this was happening in bond markets. One of those was the buying of US Treasury bonds by other countries' central banks. As readers know, we think that this support of the dollar by, in particular, Asian central banks, is one of the biggest risks overhanging world markets. That risk was highlighted by the reaction of markets on 22nd February, when an official at the South Korean central bank said that they would be diversifying the currencies in which they hold their foreign reserves. The dollar fell 1.3% against the euro and the yen. The US stockmarket fell by 1.5%. The price of oil jumped by 4%, and gold jumped 1.7%. The South Korean central bank rushed to clarify the position, saying it had no intention to sell. It would effectively just buy fewer in the future. So thankfully the $200bn South Korean reserves, of which 70% is in dollars, will not be flooding the market. This event gave us a glimpse of the potential for the markets if even just one Asian central bank cracks, and tries to head for the exit door, and sells dollars before the others do. It also highlighted another of Greenspan's concerns: that exporters to the US (importers into the US) have allowed their margins to contract to such an extent that any further dollar falls will be passed onto the consumer, thus pushing inflation upwards.

Greenspan also debated the politicians favourite subject, future pensions. One final sentence of note was: "*Yet history cautions that people experiencing long periods of relative stability are prone to excess.*"

One of the questions that Greenspan was asked during his testimony was that if inflation is under control, why was the Fed increasing interest rates? Greenspan replied that inflation was 'contained' rather than controlled. He then went on to explain that the Fed had moved interest rates down sharply because of financial deflationary pressures, and that the rate had been moved to levels below those considered to be long term sustainable rates. When it became clear that "excessive accommodation" was no longer required, it was decided to withdraw it. If not, we would expect "significant inflationary imbalances". The Fed are removing the accommodation as quickly as possible, and as long as the market thinks it can. The Fed are aiming for an interest rate level, which creates a degree of stability, and removes "any sense of excess". He then said that the Fed did not know what that actual rate was. The level was not stable, and moved around. What the Fed committee is trying to do is judge where we are at all times. The rate was not something they could predict. It is very interesting that central bankers are increasingly pointing out that there is no set answer to an economic question. Greenspan kept pointing out, when talking about Bush's plan for using Private Accounts to solve the US pensions problems, that we do not know to what extent financial markets are discounting the future pensions deficit. Mervyn King, the governor of the Bank of England, told a questioner at a presentation who asked what the Bank's model predicted, to go outside and wash his mouth out with soap if he thought that there was a model that could predict the outcome. He said if it could all be done by a mathematical model, there would be no need for a committee to set policy. The interesting point in Greenspan's reply was the term "sense of excess". He is clearly concerned at how financial markets have priced risk out of their equations. This is best seen in the historically low spread in interest rate differences between Treasury bonds and "high yield" bonds, (those rated below investment grade). We can assume therefore, that whilst these spreads remain so low, the Fed will continue to raise interest rates. Like the Fed, we can not know at what level interest rates will have risen before markets react to them negatively. Our best guess is that this will be later this year. US interest rates remain a dominant feature of world markets, despite an increasing disparity between interest rates in different economies around the world. Japan has rates of next to nothing. Europe's economic lethargy makes a cut in interest rates more likely. As this unfolds, the odds on our prediction at the beginning of the year, that markets will become less correlated, are rising. Diversification is becoming more important to all investment portfolios.

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