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Excess Liquidity and No Inflation!

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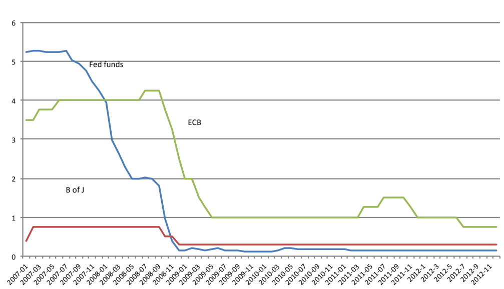
Central banks lowered official rates

In the past 6 years, central banks in all the major developed markets embraced highly stimulative monetary policies to end the downward credit spiral and to reignite their slumping economies. The central banks lowered their official interest rates to unimaginably low levels: zero and beyond. For example, the ECB recently bravely dropped its lower bound rate to -15 basis points to nudge European banks into extending more credit to businesses. The bank of Japan has had zero rates for a long time, and most recently adopted a 2% inflation target.

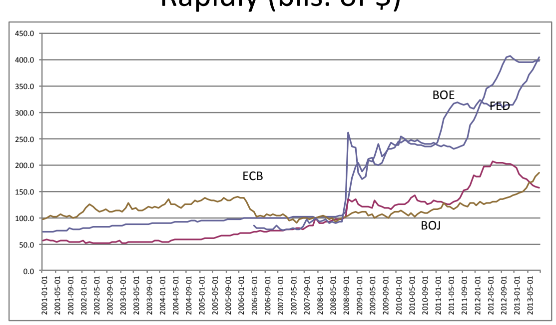
Central Bank Rates at or Below Zero



They also embarked upon QE

The central banks most important contribution to the recovery cause was their massive purchase of fixed income securities, popularly called QE. The central banks enlarged their balance sheets several times over (see chart 2). For example, the Federal Reserve's balance sheet is four times greater than it was in 2008 before they embarked upon QE. Even now in the 6th month of "taper", the Fed continues to purchase $45 billion of long maturity securities to its portfolio each month.

Central Bank Assets Are Growing Rapidly (bils. of $)



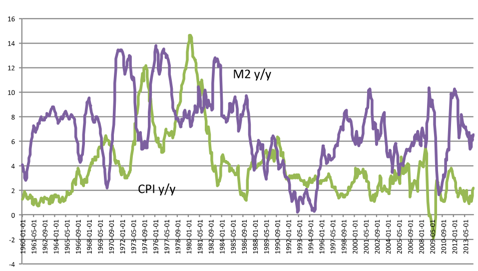
Fixed rate assets are no longer attractive

In the process of this unprecedented monetary stimulus, long-term interest rates have plunged to unattractive investment levels and massive pools of liquidity have been created. Waves of liquidity have rolled rapidly across the oceans to all corners of the earth driving asset prices, mainly equities in the US and real estate in Asia, beyond their historic valuation peaks. (See CAMRI Global Perspectives, Issue 13, May 2014).

Money supply growth accelerated

Traditional money supply growth rates have jumped in accordance with the central banks' bloated reserve positions. In any past period, such central bank behavior would have catapulted domestic economies into escalating problems of inflation that would have eventually spread throughout the world. Respected economic proponents of the equation of exchange (money times velocity equals price times quantity, MV=PQ), would have been shocked to learn that price inflation of goods and services have remained essentially stable, and in some countries have decelerated after excessive monetary creation.

Inflation Is Not Keeping Up with Money Growth



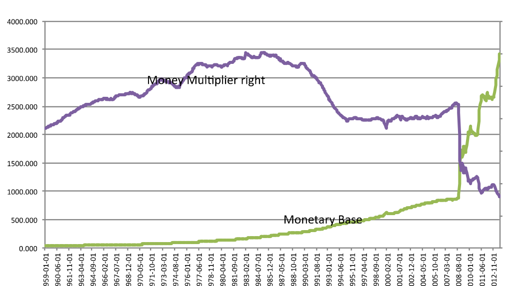
Prices follow money

Monetarists have argued that there is a lag between acceleration in money growth and subsequent inflation; however, the expansion of central bank balance sheets has been going on for nearly 6 years, and still there is no inflation.

Banks became more prudent lenders

Another argument made by monetarist inflation hawks has been that the banks have been reluctant to lend following the credit debacle in 2008, and therefore money wasn't enlarged in proportion to reserve creation. As the following chart reveals, the money multiplier (the ratio of M2 to the monetary base) in the US plunged from 2009 onwards, coincident with the explosion in the Fed's balance sheet. It is true that banks have instituted more prudent lending standards in the aftermath of the great credit recession, and they have been subject to more strict regulatory oversight and higher risk-based capital standards. Nevertheless, bank lending has increased, but not as much as the central bankers had hoped.

The Money Multiplier Plunged



Lethargic real economic growth

In spite of this massive monetary accommodation, economic recovery throughout the developed economies has been lethargic. In the three main developed economic regions, real economic growth in the past 5 years of economic recovery has averaged 1.8% in the US, 0.5% in the Euro zone, and 1.2% in Japan.

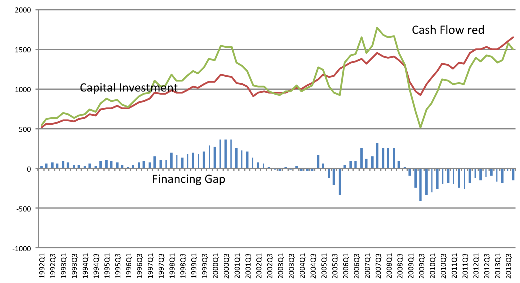
Consequently, the massive liquidity that central banks created has not produced acceleration in inflation contemporaneously or with a lag, and it has barely boosted real economic growth. Therefore, where did all the money go?

A partial answer is that banks that received central bank reserves were extremely cautious with it and reinvested most of it back with the central banks. They didn't use it to expand their balance sheets as the central banks had done.

Corporations have not expanded operations

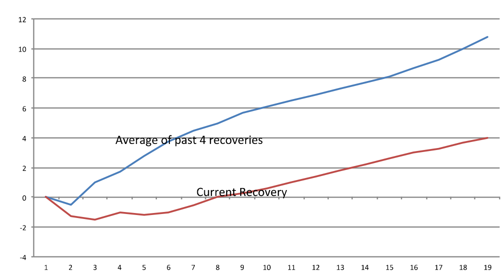
Central bankers have been frustrated by the lack of credit extension. Of course, businesses, particularly in the US, have not needed to maximize their bank credit lines as they have refinanced all of their outstanding debt and more in the vibrant, low-cost bond markets.

Corporations Underinvesting Cash Flow ($ Bils)



Moreover, their operations have been extremely profitable throughout the past 5 years. Corporations have amassed sizable pools of capital; however, they have not fully utilized them to finance new real investment. Similarly, corporations have also been hesitant to employ new labor. Employment growth in the present recovery has been unusually sluggish compared to all of the business recoveries in the past 50 years.

Employment After Recessions
Percent from trough



Corporations boost their stock prices

Corporations that were not expanding their operations used some of their retained earnings to buy back outstanding stock and increase their dividend payouts. These financial decisions boosted stock prices in most of the developed world's equity markets. Low bond yields and the threat of higher interest rates in the near future also stimulated portfolio shifts from bond market investments into stock markets, thus propelling stock prices higher.

A significant amount of liquidity was invested externally

Some of the liquidity created by central banks in the developed world splashed over into developing markets everywhere causing large equity gains, particularly in real estate markets throughout Asia.

Unlike in the past, excessive monetary creation has not stimulated inflation as traditionally measured by goods and services in the economy. Instead, it caused inflation to permeate financial markets, raising prices of financial assets and real estate.

The rich became richer

One theme seeps through all of these disparate economic and financial events of the past 5 years: Asset holders have prospered whether they are equity holders in the west, or real estate holders in the east. In contrast, workers mainly in the developed world have been passed by in the wealth creation parade. If they were not wealth holders at the start of the recovery, or did not manage to keep their jobs in the great recession, they suffered significant loss relative to the asset holders. Numerous academic studies and several household surveys conducted by the Federal Reserve and the Department of Commerce have found that the top 1% of income earners own the vast majority of equity assets.

As a result, one of the great-unintended consequences of the unprecedented monetary stimulus of the past 5 years has been to widen the wealth gap everywhere. If widening the wealth gap was partially intended in order to stimulate more new employment by the wealthy and by the highly profitable corporations it failed.

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	KEY INDICATORS TABLE (AS OF 25 June 2014)							
INDEX	**LEVEL (LC)**	**%1MO (LC)**	**%1MO (USD)**	**%1YR (LC)**	**%1YR (USD)**	**INDEX**	**LEVEL**	**%1YR**
S&P500	1959.53	3.27%	3.27%	25.99%	25.99%	3MO LIBOR	0.23	-15.30
FTSE	6733.62	-0.94%	0.00%	14.64%	26.18%	10YR UST	2.56	-1.88
NIKKEI	15266.61	5.56%	5.77%	19.68%	14.89%	10YR BUND	1.26	-30.10
HANG SENG	22866.70	0.65%	0.67%	19.32%	19.41%	10YR SPG	2.64	-47.94
STI	3261.54	-0.50%	-0.29%	8.84%	10.37%	10YR SGS	2.37	-11.51
EUR	1.36	0.00%		4.22%		US ISM	55.40	10.80
YEN	101.87	-0.10%		4.15%		EU PMI	51.90	8.10
CMCI	1514.29	0.77%		6.07%		JP TANKAN	12.00	250.00
Oil	106.50	2.06%		11.73%		CHINA IP	8.80	-4.30

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)
S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
CMCI: Constant Maturity Commodity Index (CMCIPI)
Oil: West Texas Intermediate prices, $ per barrel (CLK1)
3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)
10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)
10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)
10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)
US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
EU PMI: Purchasing Managers' index for the 17-country EU region (PMITMEZ)
JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
CHINA IP: China's Industrial Production index, with 1-month lag (CHVAIOY)
LC: Local Currency