**Investment Thoughts: The Cost of Money**

Perhaps you have seen one of those reality shows where people are dispatched to some remote island or jungle to survive on their own wits and local resources, perhaps as a member of a “tribe” or competing team? We see the individual suffer from the challenges of the environment as they fashion shelter, look for food and avoid injury. I’ve thought to myself that at times of extreme peril in these shows, the people can’t ever really be lost or totally at the mercy of nature. After all, they are being filmed by a film crew and presumably the film crew has a dry bed and food somewhere nearby, or even a helicopter on standby. So, it is confusing to determine whether the participants are truly on their own and should take some sort of action, or if they should wait for a rescue of sorts when in peril. This is not so different from our financial markets where asset prices and risks become distorted when there is a big supply of government money offered at near zero interest.

Government intervention in markets creates risk distortions in capital investments. Government bailouts allocate public money to failed areas of the private sector, competing with successful ventures needing capital to grow. How do investors place their bets on asset prices when, due to government policy intervention, they can suddenly change irrespective of underlying fundamentals? The player in the investment survival reality show is looking at the surrounding conditions and making judgments accordingly, only to see that the “TV crew” has set a table of free food nearby. What is now the value of a fish hook and line in a survival setting when someone shows up on the set with food and a microwave?

**Chart Nr.1** below, shows three episodes of stock market declines followed by monetary policy stimulus from the Federal Reserve known as quantitative easing, or more colloquially, money printing. Operation Twist was an effort to push down long term bond yields so as to lower effective mortgage rates. Europe has embarked on their own version; Long Term Refinancing Operation (LTRO). It is also money printing and joins the defense of the global debt pile. In fairness, the British are as well.

![Chart Nr.1](image-url)
**Chart Nr.1** also indicates to me that it is not only corporate earnings that have driven the stock market higher, but also the excess liquidity provided by the Fed. Investors today hold a riskier basket of assets in response to the low interest rates that are the result of money printing. This sets us up for more economic ups and downs as investors move in packs into and out of different assets.

With interest rates at a “can’t go much lower” level (see **chart Nr.2**), we may see in the next year or so rates lifting higher. This may sound rather banal, except if we appreciate that falling interest rates have been a primary driver of investment returns since the time Volker broke the inflation grip in 1981.

Falling rates have allowed bond markets to best equities over the last ten years on a total return basis. Falling rates have allowed refinancing, low costs of capital etc., all which have supported higher profit margins. What happens when the QEIs and Operation Twists end? Negative real interest rates have been driving stocks higher even though profit margins are coming under pressure from rising labor, food, energy and raw materials prices.

If the Fed stops its purchases of Treasury securities will we see a stock market drop as we did at the end of QE I and QE II (**chart Nr.1**)? To be sure, this may seem like Fed tightening, but it is the availability of credit that will weigh more in the equation and in general the big picture of global growth.
A major element of global growth is energy prices. To look more closely at the gasoline cost factor we wonder, do rising prices create a wall for consumer spending and a reprise of the “soft patch” we had for our economy last summer, or, are job conditions more supportive this time around? **Chart Nr.3** seems to indicate that the gradual rise of gasoline and the moderating of other household debt expenses have allowed consumer confidence to remain resilient. It seems to me the improving jobs picture is the key difference in sentiment.

![Chart Nr.3](image-url)
When looking over our concerns of slowly rising interest rates as a result of monetary inflation, profit margin pressure and higher energy costs, it seems the number of positive surprises awaiting us is diminishing while geopolitical and foreign financial risks are prepared to enter the scene unannounced. At current levels for the U.S. stock market we are revisiting the highs seen in 2008 before the time of “the unpleasantness.” Setting aside a renewal of the European debt crisis or a negative surprise from China, markets need not go through another crash, though if revenue growth and profit margins fade, stocks may be in oversupply at levels above 1400 S&P 500. 

**Chart Nr.4**

The road to the destination is not the reason for the trip

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