

Commentary

November 3, 2014

The Markets

Are central banks throwing a progressive party?

You know, the kind of party where folks travel from house to house feasting and drinking and enjoying the proffered hospitality. For years pundits have speculated about what will happen to the U.S. stock market party when the spiked punch bowl of quantitative easing is gone. Last week, they got an unexpected answer: Come on over to Japan's house.

On Wednesday, the U.S. Federal Reserve announced October marked the end of its third round of quantitative easing (QE). Since late 2008, the Fed has purchased trillions of dollars of government and mortgage-backed bonds in an effort to spur economic growth (by increasing liquidity and lending) and head off deflation. In October, *The New York Times* reported, "The good news is that economy has been growing remarkably steadily since the middle of 2009... Still, the pace of growth has been perpetually disappointing for anyone expecting or betting on a return to the pre-crisis trend."

Not long after the Fed announced QE closing time, Japan's central bank, Bank of Japan (BOJ), startled stock markets with a Godzilla-sized surprise – it was expanding an already significant quantitative easing program. As if that weren't enough, the President of Japan's Government Pension Investment Fund (the world's largest pension fund) said the fund's assets were being reallocated. Instead of having 60 percent invested in bonds, it would keep 35 percent in bonds and move the balance to stocks. The news electrified stock markets. *Barron's* reported:

"Stocks soared around the globe while the yen plunged against the dollar and the euro. Extending the previous week's surge, the major U.S. equity gauges ended at records on Friday, while stocks in Tokyo jumped more than 7 percent on the week to the highest level since November 2007. Not to be left out, European stocks gained 3 percent, their best weekly showing since last December."

Barron's also pointed out the real effect of a falling yen was to export deflation to Japan's trade partners. The drop in the value of the yen on Friday translated into a \$1,500 price cut on a \$60,000 Lexus or Acura, increasing competition for luxury German automobiles.

So, what's the next stop for revelers at the central bank fête? *The New York Times* speculates it may be the Eurozone.

Data as of 10/31/14	1-Week	Y-T-D	1-Year	3-Year	5-Year	10-Year
Standard & Poor's 500 (Domestic Stocks)	2.7%	9.2%	14.9%	17.2%	14.1%	6.0%
10-year Treasury Note (Yield Only)	2.3	NA	2.5	2.2	3.4	4.1
Gold (per ounce)	-5.6	-3.1	-12.1	-12.2	1.9	10.5
Bloomberg Commodity Index	1.0	-6.4	-6.0	-7.7	-2.4	-2.6
DJ Equity All REIT Total Return Index	2.0	23.6	18.3	15.2	18.9	8.7

S&P 500, Gold, Bloomberg Commodity Index returns exclude reinvested dividends (gold does not pay a dividend) and the three-, five-, and 10-year returns are annualized; the DJ Equity All REIT Total Return Index does include reinvested dividends and the three-, five-, and 10-year returns are annualized; and the 10-year Treasury Note is simply the yield at the close of the day on each of the historical time periods. Sources: Yahoo! Finance, Barron's, djindexes.com, London Bullion Market Association. Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly. N/A means not applicable.

WHY ARE PEOPLE WORRYING ABOUT DEFLATION? Deflation is a general decline in prices. For anyone who has been struggling to make ends meet that may not sound all bad. In fact, it's not always bad. According to the *Federal Reserve Bank of St. Louis*, between 1876 and 1879, prices in the United States fell by about 5 percent per year, on average, while the economy grew at a 7.6 percent clip.

Of course, deflation is not always good either. Financial crises in the United States during 1890, 1893, 1907, and the early 1930s were followed by periods of lower economic growth and deflation. *The Economist* described the harmful effects of deflation like this:

"It is a pernicious threat, all the more so because, at its onset, it seems almost benign... The belief that money made tomorrow will be worth less than money today stymies investment; the belief that goods bought tomorrow will be cheaper than goods bought today chokes consumption... Wages, incomes, and tax revenue all stall,

undermining the ability of households, businesses, and governments to pay their debts – debts which, in real terms, will grow more burdensome under deflation.”

Deflation is a greater threat in Europe than in the United States. *The European Central Bank's* most recent bulletin distinguished between deflation (a significant and persistent decline in prices that becomes entrenched in expectations) and disinflation (a process of decelerating inflation that may lead to negative inflation rates but is a temporary state of affairs). Italy, Spain, Greece, Sweden, and Israel experienced negative inflation in September, according to *The Economist*. It reported, “The IMF [International Monetary Fund] recently put the odds of deflation in the euro zone – defined as two quarters of falling prices in a 12-month span – at 30 percent in the coming year.”

Weekly Focus – Think About It

“And so it began: a growing realization that the vampire genre is positively swollen with economic questions. And the zombie genre? Maybe more so. Economic issues take center stage in many undead narratives – and when they don't, they're still lurking in the shadows.”

--Economics of the Undead, A collection of essays

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* Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

* Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features.

* The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. You cannot invest directly in this index.

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* The 10-year Treasury Note represents debt owed by the United States Treasury to the public. Since the U.S. Government is seen as a risk-free borrower, investors use the 10-year Treasury Note as a benchmark for the long-term bond market.

* Gold represents the afternoon gold price as reported by the London Bullion Market Association. The gold price is set twice daily by the London Gold Fixing Company at 10:30 and 15:00 and is expressed in U.S. dollars per fine troy ounce.

* The Bloomberg Commodity Index is designed to be a highly liquid and diversified benchmark for the commodity futures market. The Index is composed of futures contracts on 19 physical commodities and was launched on July 14, 1998.

* The DJ Equity All REIT Total Return Index measures the total return performance of the equity subcategory of the Real Estate Investment Trust (REIT) industry as calculated by Dow Jones.

* Yahoo! Finance is the source for any reference to the performance of an index between two specific periods.

* Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.

* Economic forecasts set forth may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

* Past performance does not guarantee future results. Investing involves risk, including loss of principal.

* You cannot invest directly in an index.

* Consult your financial professional before making any investment decision.

* Stock investing involves risk including loss of principal.

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