Markets are discounting government, not earnings

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While stockmarkets are suspended from **central bank** balance sheets like marionettes, financial news isn't important. The economy, company earnings, demographics, the insolvency of pensions… no, nothing but money printing, and the potential for money printing, matters any longer.

Financial markets pundits, including me, fervently discuss the markets. We watch data releases, comment on valuations and examine geopolitics.

But financial markets are not markets any longer. They're indicators of whether government intervention is working.

Markets are supposed to "discount" the future of whatever financial asset they're pricing. That's a clever way of saying they predict how it will perform and come up with a price based on that.

Higher company profits in the future mean a higher share price. Higher inflation expectations mean a lower bond price. Lower mortgage defaults mean better mortgage-backed security performance, increasing their value.

But these days, markets are discounting government intervention, not market action. If you can understand this, it changes the nature of investing completely.

For example, it explains the days of "bad news is good news". After the 2008 crisis abated, bad news would make the stockmarket rally because it carried the promise of more government intervention. The stockmarket was discounting that government intervention instead of the bad news.

So if you want to predict the stockmarket's performance today, the key question is not about profits, the unemployment rate, price/earnings ratios or GDP growth. The key question is the efficacy of government intervention in the economy. **Does the vanity of central bankers hold up in practice**? And will it hold up the stockmarket forever?

How long can they goose the stockmarket?

I'm a firm believer that all government policies find a way to fail. The ways in which they do so are surprisingly diverse. But it's always just a matter of time before someone finds the unintended consequence.

Often those are predictable and you can invest to profit from the resulting debacle. Perhaps there should be a newsletter dedicated to the idea of profiting from government policy's unintended consequences?

But for today's *Capital %26 Conflict*, my position is a little different. It's a twisted version of John Maynard Keynes' famous but unverified quote that "markets can remain irrational longer than you can remain solvent."

We don't have markets any more. We have central bankers and governments in charge of prices. And so the question has changed: can central bankers and governments keep markets irrational longer than you can remain solvent?

In other words, how long can central bankers forestall the crash?

Can patient investors with cash on the sidelines remain patient long enough for the buying opportunity they're waiting for to finally emerge?

Can those punting on the failure of government attempts to goose the stockmarket hold on to their bets for long enough to watch them come to fruition?

How long will it take?

Too long, in my opinion.

This idea is also known under another maxim: don't fight the Fed. The idea is that **central bankers are too powerful** for you to bet against. They won’t lose control.

The only problem is, the Fed and its peers around the world are now so dominant in financial markets that they impact all of them. You can’t go elsewhere – they’re everywhere. Except maybe here.

The other alternative is betting that governments can keep markets afloat and investing your funds under their protection. But that goes against faith in markets and scepticism of government intervention.

So do you join the drugged-up orgy of financial gains or stick to your morals to avoid the hangover you know is coming?

Perhaps I should’ve used the less controversial musical chair analogy. Like Citigroup’s CEO when he justified his company’s dodgy lending standards in 2007: “As long as the music is playing, you’ve got to get up and dance,” he said. And you know how that turned out.

Anyway, this is the key question facing investors today: do you join a doomed rally because you don’t know how long it will last?

Our various editors at Southbank Investment Research all have a different answer to that one. We don’t have a company line. I’ve sent out a request for how they see things, so don’t miss tomorrow’s *Capital %26 Conflict.*

By the way, don’t think that the UK is somehow set apart just because the Bank of England has been comparatively quiet. During the financial crisis, the Fed’s **quantitative easing** (QE) policies caused all sorts of bizarre shifts around the world. China’s currency, Australia’s banks and the Swiss central bank’s balance sheet all experienced bizarre events thanks to QE on the other side of the world.

Just because the Bank of England is seemingly quiet, doesn’t mean central bankers aren’t goosing our markets too. How many shares on the British exchange does the Swiss National Bank own, for example.

While the West and Japan are in the grip of central banks, the Chinese have a more direct form of intervention. The government just buys stocks. About 120 billion pounds worth so far. More on that tomorrow too.

The price of failure

The wheels always come off government policy eventually. The question is, what does that moment look like?

Historically, when it came to overinvolved central bank policy, the crisis was always an inflationary one. The price of failure was higher prices. **Unable to stop printing once they start**, central bankers overdo it eventually.

But the nature of today’s crisis is deflation. That’s offsetting what I think of as the central banker’s accountability mechanism of inflation.

For now.

Until next time,

Nick Hubble
Capital %26 Conflict