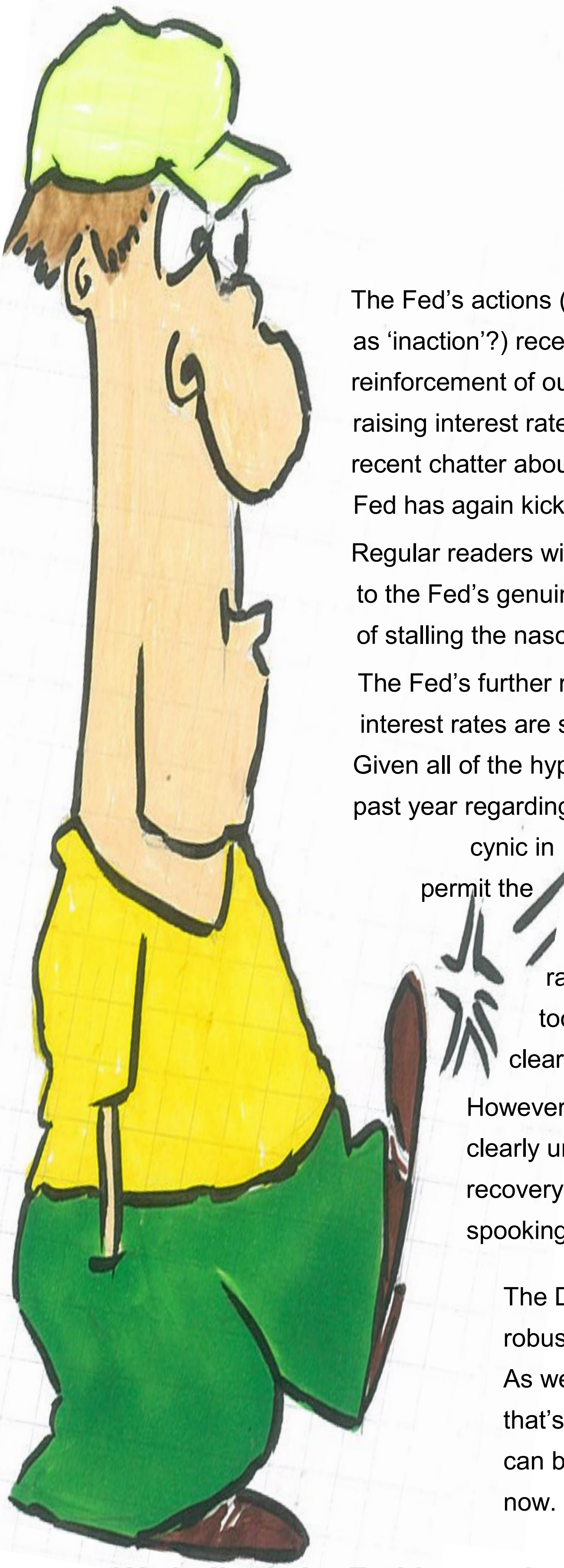
The Fed kicks the can further down the road



The Fed's actions (or should that more accurately be described as 'inaction'?) recently with respect to interest rates provides further reinforcement of our long-held view that the Fed isn't really serious about raising interest rates (despite it's tough talk). Despite all of the market's recent chatter about supposed timelines for interest rate rises, the Fed has again kicked the interest rate can down the road.

Regular readers will know that we've been skeptical for some time now as to the Fed's genuine commitment to take action on interest rates - for fear of stalling the nascent US economic recovery.

The Fed's further recent inaction led to a surge in US equity markets, as interest rates are set to remain at record low levels.

Given all of the hype emanating from the US media and analysts over the past year regarding how robust the supposed US economic recovery is, the cynic in me wonders exactly what economic conditions will ever permit the Fed to raise rates?

The Fed continues to talk tough with respect to interest rates, recognising the dangers of keeping rates too low for too long. It also points to economic growth in the US as clear evidence that its 'easy money' policies are working.

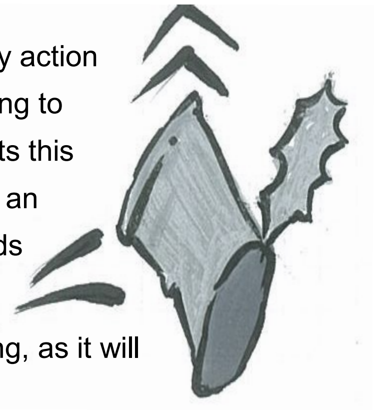
However the Fed can't have it both ways. In our view the situation clearly underlines the relative fragility of the US economic recovery – something the Fed won't directly admit for fear of spooking markets.

The Dow Jones at record levels does not necessarily reflect a robust economy.

As we've said before, it's more a reflection of an equity market that's been pumped full of Fed-administered hot air. The same can be said of the property bubble that exists in the US right now.

We believe the Fed knows however that it cannot actually raise interest rates anytime soon because of the potentially negative economic consequences.

For several years now there have been calls for Fed action on interest rates. For example as far back as February 2012, President and CEO of the Federal Reserve Bank of St. Louis, James Bullard, argued “the Federal Reserve should start raising interest rates next year.” At the time he disagreed with the Fed's decision during January 2012 to keep interest rates exceptionally low through to late 2014 to bolster the US economy.



Comments last September by the Fed suggested that there wouldn’t be any action on interest rates until at least mid-2015, with Fed Chair Janet Yellen pledging to keep interest rates near-zero for a “considerable time”. The Fed’s comments this past week have confirmed what we thought all along - that this was always an unrealistic timeframe. Now markets are talking about a potential rise towards the end of 2015.

Financial markets are comfortable with the ‘easy money’ scenario continuing, as it will help maintain the value of already-inflated share and property investments.
For now the game of musical chairs continues and the day of reckoning gets pushed back a little further.

As James Bullard argued back in 2012, many years of near-zero rates risks causing "disaster." Keeping rates low for several quarters is very different from keeping them there for years, which punishes savers. The Fed's easy money policies have distorted market prices and encouraged destabilizing financial speculation.

But the far bigger concern lies in the immediate and longer-term future: the economy and financial markets have become so dependent on QE and artificially-suppressed interest rates that it will be very difficult for the Fed to reverse these policies without major repercussions.

The danger is that they won't be reversed in time - resulting in a different (but equally serious) set of potential consequences. The Fed has a well established tendency to not recognize the effects of its loose monetary policy, nor to tighten, until it's far too late.

Our view is supported by long-time gold industry-watcher, Laurence Williams. He commented that “recent statistics have shown that the U.S. ‘recovery’ is far from strong despite the spin put on it by politicians and the Fed. Given a lack of inflationary pressure any Fed rate increases are thus likely to be both modest and gradual and keep them negative in real terms.”

Industry consultants Metals Focus also share similar sentiments and comment in their latest weekly letter that “the realization that rates will remain lower for longer will not only see the unwinding of short bets, but also encourage investors to reconsider the investment case for precious metals.”

All of this reinforces our positive stance on gold – and potentially silver. Much of the decline is silver and gold since the beginning of the year has been due to the rise in the rampant dollar – the dollar index has risen by around 10% since January 1 – which makes any decline in metal prices less relevant in most other currencies.

Silver demand is always hugely difficult to predict, which accounts for much of the metal's volatility. It has a substantial industrial usage element – much of which nowadays is in potential growth sectors like electronics, solar power and biocides now that the decline in photographic usage has largely run its course. There remains a very strong investment element as has been seen in silver ETFs, purchases of silver coins and continuing strong demand in major consumer markets like India where price declines tend to stimulate demand further.

So whilst we maintain our positive stance on gold, it's also worthwhile reflecting on the leverage that silver offers investors.

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