TECHNICAL SCOOP
CHART OF THE WEEK

Charts and commentary by David Chapman

January 23, 2015

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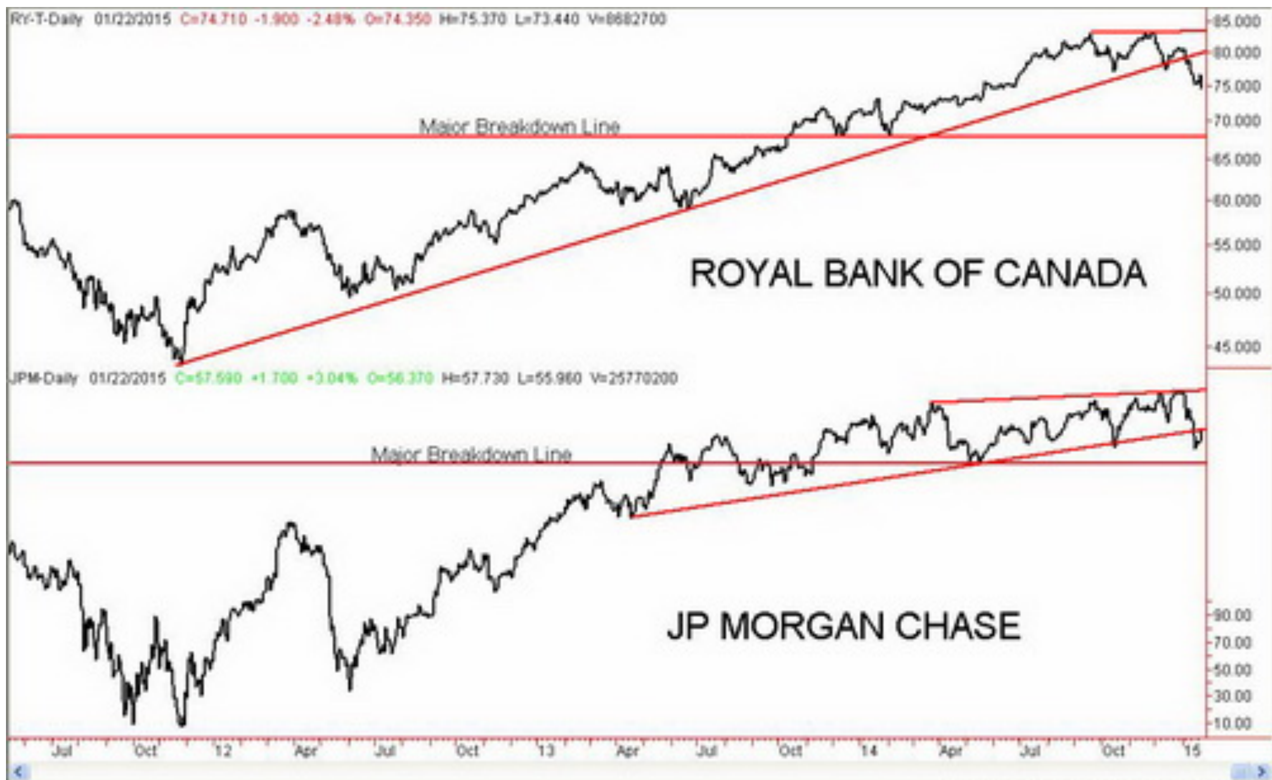
Banks Tipping Over?



Charts created using Omega TradeStation 2000i. Chart data supplied by Dial Data

The central banks of the world continue to shock markets. "Shock" was a word used to describe the completely unexpected rate cut by the Bank of Canada (BofC) on Wednesday January 21, 2014. It was not quite in the same league as the shock delivered by the Swiss National Bank (SNB) the previous week when they unexpectedly released the Swiss Franc from its peg with the Euro. There were some similar if opposite effects. The Swiss Franc soared that day while the Cdn$ "tanked" losing 2% against the US$ on the day.

The Cdn$ is down 3% so far on the week and 6% so far in 2015. Trading desks that were caught with too many Cdn$ suffered immediate losses. Apparently, there were margin calls against some firms. That was not unlike what happened with the Swiss Franc although there was no word of any firms going under as a result of the BofC's surprise move.

On Thursday January 22, 2015 the European Central Bank (ECB) came in with its own version of "shock and awe" when they announced a quantitative easing (QE) program of €60 billion a month until September 2016. That was above the expected € 50 billion. At current exchange rates (that changes every day as the Euro sinks) that is just under US$75 billion/month although some say it is equivalent to the US's QE3 of $85 billion/month. The impact on the Euro was immediate as the Euro fell another 2.0%. Stock markets were delighted as stock markets in the US, Europe and Canada all rallied on the news. All the stock markets seem to believe that the punchbowl should continue.

Shock and awe is hardly a term one should be using when referring to the central banks of the world. One is supposed to think of confidence, prudence and sound money management. Take the BofC as an example. Its purpose and role is "to promote the economic and financial welfare of Canada". The BofC has four main areas of responsibility (which is the same with all central banks) – monetary policy, financial system, currency, and funds management.

Cutting interest rates on one hand while worrying and warning about sharply rising household debt (now 163% of household income) and once again fretting about Canada's overvalued housing market (by 30% according to some analysts) does not exactly engender confidence. Watching the currency collapse to multi-year lows does not engender confidence in the currency or the country. The interest rate shock came on top of the oil price decline shock although if you just drive as most of us do the oil price decline is a boon. The interest rate cut was designed, according to the BofC to offset the decline in oil prices to some extent and the oil price decline impact on debt-to-disposable income and jobs. The market ignores the overvalued housing market and high debt to income ratio at their peril.

The expectation is that lower interest rates will set off a boom in investment by corporations and spur consumer demand by consumers borrowing more. Canada, like all western countries has had low interest rates for years and it has failed to set off a major investment boom nor has it sparked a sharp rise in consumer spending. The exception may be in housing where low interest rates have encouraged people to assume large mortgages and buy up helping to push home prices into the stratosphere particularly in major cities such as Toronto and Vancouver. Yet it was sharply rising housing prices financed with cheap money that helped trigger the financial collapse of 2008.

Yes exporters should benefit from a lower Cdn$ and exports make up roughly 30% of GDP but Canada's prime export has been oil and given the collapse in oil prices pumping out more oil is not likely. On the other hand the lower Cdn$ makes imports more expensive and most consumer goods and even a number of foods are imported. That could raise the price of food and clothing amongst others.

Sudden unexpected interest rate cuts; huge QE programs; sudden unexpected unpegging of a currency – these shocks are not what one expects from a prudent central bank. The question begs. Are the central banks losing control? Take QE in the EU as an example. Germany, the strongest economy in the EU, is

not happy about this at all. But Germany was out voted. The EU has said €60 billion/month but the rub is that the national banks of each EU country would have to buy back its own sovereign debt. The most credit worthy debt is that of Germany. So just how much German debt can the Bundesbank buy back? In the case of the Greek National Bank probably very little unless it is their desire to go bankrupt. Greece is on the cusp of possibly electing a government that is opposed to austerity imposed upon by Germany and might decide Greece is better off outside the EU and the Euro. If that happened what does that do for the Euro?

On the day of the ECB announcement the US$ soared while other currencies swooned. No matter how one looks at this, this is not positive. From 1980 to 1985 the US$ soared against other major currencies. Eventually everyone including the US became concerned about the soaring US$. This resulted in the Plaza Accord of September 1985 that resulted in a massive devaluation of the US$ against the German Deutsche Mark and Japanese Yen. The sharply rising US$ had caused considerable problems for US industry.

Once again from 1995 to 2001 the US$ soared. The huge rebound in the US$ got underway in early 1995 as a result of this time Japan finding the high value of the Yen was hurting them and the US agreed with Japan to help push the Yen lower and allow the US$ to rise. After February 2002 the US$ reversed course once again and collapsed into the lows of 2008. Once again the high value of the US$ was hurting American exporters and the desire was to bring it down. As well the September 2001 attacks left the US vulnerable and they set about to devalue the US$ against other major currencies.

Since the world ended Bretton Woods and the decoupling of the US$ from Gold in August 1971 currencies have embarked on wild rides. A better description might be "gross instability". The current rise in the value of the US$ against the major currencies is just another example of currency instability. At some point the value of the US$ should become too high and there will once again be a clamour by American business to bring down the value of the US$. Wild and rapid currency movements are not a sign of a stable economic system. It is the sign of a financial system becoming increasingly destabilized.

Everyone, although by everyone I mean Japan, the US and now the EU have carried out QE. But has it done any good? Japan has been on varying degrees of QE since the early 1990's and they have held interest rates artificially low for years. The Japanese economy is once again sliding back into yet another recession. Their banking system still needs reform. The US has gone through three rounds of QE since 2008 yet at best their economy remains moribund even as every economic number is cheered that the US is leading a great recovery. The major beneficiary of all the QE has been the stock market and the 1% plus the professional class. For most of the rest of the US, underemployment (or unemployment) remains the norm.

So what happened to all of the QE? Sure, the unemployment rate fell but much of it was due to part-time jobs. Consumer debt has been growing at best very slowly and today remains below levels seen prior to the 2008 financial collapse. But government debt has grown considerably and the liabilities of those outside the US has also grown even more. The US is the most indebted country in the world with $18 trillion plus of debt. Yet the US somehow maintains its AA+ credit rating only because they can service it by adding the interest payable to the debt. As to all of the debt outside the US in US$, it is estimated at

roughly $9 trillion and given the currency of all other nations have fallen against the US$ it now means that those borrowers have a lot more of their home currency to pay back (to purchase the US$ necessary to repay the loan). There is growing concern that repayment problems could rise.

Given low growth on the consumer side it is small wonder that the overall growth of the economy has been sluggish at best. But the stock markets have soared and the response from both the cutting of the key interest rate by the BofC and the massive QE program announced by the ECB had yet again another positive impact on the stock market. They soared. But is it at the risk of creating a bubble? And bonds have soared as well. Is that also at risk of creating a bubble? Everyone is reminded that bubbles eventually burst as was seen with the internet/high tech bubble of the late 1990's and the housing bubble of the 2000's. Not only did they burst but each time the central banks were called in to the rescue. And in the case of the bursting of the housing bubble the taxpayer was called in to bail out the financial institutions that were at the heart of creating the bubble in the first place.

The actions of the SNB, the BofC and the ECB and before that the BOJ smack of possible desperation and panic setting in. The Fed is not immune as their day could most likely come as well.

So what has this got to do with the Banks? The chart shown at the outset was of the largest bank in Canada and the largest bank in the US. The banks are/were at the heart of the 2008 financial crisis. Following the 2008 financial crisis there were calls for reform of the banking system. The banks in both the EU and especially in the US fought successfully against it. After all it would put a serious crimp in their operations. And who wants government interfering in how the private sector works.

But as the chart of the Royal Bank of Canada (RY-TSX) and JP Morgan Chase (JPM-NYSE) demonstrates they both appear to have broken down from a long up-trend. No they have not yet broken down sufficiently. There is still time to recover and move to new highs. But banks are all about debt on their books. With record amounts of debt outstanding and the central banks creating the kind of conditions that resulted in the bursting of previous bubbles should one really feel that they this time they will get lucky?

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