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The Ultimate REAL End of Cheap Money

By George M. Klar…..President, Alternativ Solution Inc.

Eleven years ago, one of the world's most influential journals, The Economist**,** published an article titled ***"The End of Cheap Money"***. That was April 2004.

The article's theme was that money had "never been so cheap" in recorded history in USA, Europe or Japan. Warning signs appeared indicating inflation could rise (albeit modestly due to excess capacity) causing rates to rise. The US Treasury yield curve was anchored at 1% for short funds and 5% for longer term funds.

The article went on to explain that super loose money policy was fueling all sorts of potential asset bubbles. Excess liquidity (caused by the Fed) was spilling into real assets and encouraging excessive borrowing to support speculation. As evidence, The Economist pointed to record high home prices in the US, UK and Australia.

So what happened next? From April 2004 to August 2008, the US Treasury yield curve steadily rose while also flattening. Asset prices (such as housing) continued to rise throughout the period. At its peak in 2007, the yield curve was a flat line, floating at the 5% level. In late 2007-08, a global financial crisis was the tipping point. Yields quickly dropped as nations went into damage control mode. The US, and later other countries, adopted QE-style programs flooding the world with liquidity and forcing yields to drop to zero for short-term funds. Seven years later, short-term funds remain near zero. Once again, there are renewed calls for central banks to raise interest rates and end the era of super-cheap money. A lot of it has flooded into housing, equities, toll-roads, airports and exotic investments.

Despite these calls, my own view is that interest rates will not rise to the levels most experts believe they should go to. The reason for my view is there are impediments preventing big upward increases to the yield curve.

The first impediment is the rate of global growth. Simply put, growth is too slow to cause the yield curve to rise dramatically. Europe and Japan remain weak, while many emerging nations are mired in conflict, Russia is in a recession, and China's growth is slowing. Excess capacity exists in many industries which explains why commodity prices are mired at such low levels today.

The second impediment is technology and innovation. Everyone knows the world is in a highly transformative and disruptive state. We do more with less and far more efficiently. This trend will continue. The big beneficiary are corporations, which willingly embrace this trend.

The third impediment is demographics. In North America, Europe and Japan, the elder population is increasing exponentially. At the same time, longevity is increasing due to medical advances and lifestyle factors. This cohort spends less per capita than the younger generation, which are underemployed and under-utilized.

The fourth impediment is a fragile global financial system. Regulatory changes since the global crisis have not solved matters. This implies governments will err on the side of caution to time rate increases. For proof, just keep watching Greece.

Implications:

Asset prices will continue to rise beyond what many analysts claim is the "correct" level. This will occur in real and productive assets (eg., homes and equities).

It implies yields and inflation will rise to lower levels than are being predicted. The real end to cheap money occurs when the impediments listed above are gone. That's still a long way off. ◻

Inside this issue:

Happy Canada Day

Congratulations:

To Paul Owen's for being awarded the prestigious Libby Slater Award by the IPEBLA in Brussels on May 19th.

ASI — What we do:

Alternativ Solution Inc. (ASI) offers consulting services on capital markets to institutional clients. We deal in topics ranging from investment strategy, risk management, asset allocation, manager selection and manager assessment.

Our recent engagements include development of investment policy (SIPP), searches for money managers, investment strategy (active vs. passive), and infrastructure. We also offer Trustees or Board members with training.

Mr. Klar is a faculty member in the Finance area at the Schulich School of Business and is a senior advisor to York University's $2.1 billion pension plan.

....Cheers, GMK