Suppression of Financial Information To Continue

The Fixing Of Prices and Rates By Officials Threatens The Role Of Markets

If you spent much of 2011 muttering, “That does not make sense,” about developments in markets, you were hardly alone. That may be classified as the good news. The bad news is you are going to get more of the same in 2012.

Markets are supposed to operate by buyers and sellers generating prices that in turn affect both current and future production and consumption. They also have a reward and penalty system of profit when you are right and losses if you are wrong. What happens, though, when prices are not set by buyers and sellers but rather by official diktat?

Consider, in no particular order:

1. Short-term interest rates in the U.S. have been forced toward 0% for more than three years;
2. Long-term interest rates in the U.S. have been pushed lower since August by Operation Twist;
3. The three largest holders of U.S. Treasury debt are the Federal Reserve, the Peoples’ Bank of China and the Bank of Japan, none of whom need to be price-sensitive;
4. Currency rates amongst the Eurozone’s members have been fixed by the currency union, forcing widespread divergences in interest rates and yield curves within the bloc;
5. The Swiss National Bank has promised to print unlimited quantities of francs to maintain a 1.20 peg to the euro;
6. The Bank of Japan has engaged in several rounds of intervention against the yen to keep it from rising;
7. China has engaged in an on-again/off-again policy of yuan revaluation with the result the currency is considered undervalued;
8. The Bank of England has been involved in quantitative easing for as long as we have;
9. The Federal Reserve has targeted asset prices deliberately, with the result no rally can be trusted as reflecting anything more than a temporary aberration; and
10. The entire apparatus of the federal government has tried to maintain home prices over whatever their market-clearing level would be, with the wholly predictable result buyers fear what will happen once the supports are removed.

Now let’s add the consequences of our fiscal policy. We have engaged in a level of deficit spending under the banner of stimulus with little actual stimulus to show for the effort. What we have produced are cumulative debt levels sufficient to convince many they can be resolved only by future austerity, future higher taxes or future higher inflation. Anyone contemplating investment in real plant and equipment today has to deal with the rational expectation tomorrow’s environment could involve some combination of all of the above.

The combination of prices being set without normal market discipline and the environment being the result of a series of ad hoc and short-term decisions made during the heat of crisis means we are literally flying blind: You know your instruments are miscalibrated and the airport has been relocated without anyone bothering to tell the mapmakers, but you still have to fly. This is not an environment conducive to good decision-making.

Finally, let’s add the inevitable results of high-frequency and algorithmic trading to this mix. High-frequency trading by its essence focuses on short-term noise as opposed to long-term signal; most algorithms rely on a combination of decisions linked to common factors and to other prices. The net result is choppy price action, a high-level of herding behavior and correlation and discontinuous price histories. While diversification arrives with time, the short-term price action tends to punish those who have done their fundamental analysis: When crowded risk-on trades reverse, the risk-off price action tends to push issues widely owned lower and issues widely shorted higher. This was the bane of the best professionals in 2011.

It will end only when markets are allowed to operate freely once again. As elections in the U.S. and the unsettled state of affairs in Europe will provide a stream of excuses leading toward short-term “solutions” throughout 2012, my advice is to prepare for more of the same.