



POTOMAC
STRATEGIC DEVELOPMENT CO.

CAPITOL MARKET REVIEW

In This Issue: State of the Union and The Federal Open Market Committee, Two Views of the US and Global Economies

Into the Close: SPX 1326 US10Y 1.99% Gold \$1714 Oil \$99.80 Jan. 25, 2012

The political world received what they were told was the “State of the Union” yesterday. No matter what data, polls and the mood of the country indicate, the President always says the State of the Union is *strong*. Global investors had little reaction to what was perceived as the opening salvo in a re-election campaign.

Ben Bernanke and the Federal Reserve’s Open Market Committee today followed up with a series of announcements that indicate the US economy is *weaker* than any politician will admit. And the Federal Reserve pledged to shower the globe with US Dollars, absent any other political remedies of the complex issues of the day.

The contrast between the *feel-good* cheerleading and hopium espoused by political leadership, and more sober assessments of GDP, housing and employment projections demonstrates that monetary policymakers have signaled to markets that current “zero interest rate policies,” (zирp,) will now be required into 2014. By adding another year of zирp, Bernanke is making a bolder political statement than Obama. Markets took notice.

There was virtually no reaction to the State of the Union message. However, as details of the Fed’s FOMC meeting hit the wires, Treasuries yields dropped, stock indexes rallied, oil again flirted with \$100/bbl and gold shot-up to \$1714, (nearly a 3.0% intraday move).

Considering that the US Treasury, and therefore the US taxpayer, is exposed to \$250 billion annually, the Fed has said this debt will be paid as close to zero as possible.

Investors who had historically owned Treasury Bills (US Treasury securities of less than one year in maturity), as cash equivalents, can now be coaxed into owning US Treasuries with longer maturities as the Fed has signaled that securities up to 5 years will not see a “back-up” in yield. (Investors will hedge and leverage around key long positions).

The only casualty of today’s action is the US Dollar. On the Fed announcement the US Dollar index dropped in relation to gold’s rally. However, the true value of the US dollar is relative to other global fiat currencies. Here, risks to traditional safe haven currencies are problematic. The Euro can no longer be trusted. Japan, has been unable to keep the Yen inexpensive relative to the Euro; (which is why German exports are now rivaling their competition in Asia). Switzerland had been a refuge for massive capital flows out of the Euro, but the SNB has blocked the exodus. The only exceptions are smaller asset based economies, (New Zealand, Australia and Canada). And these economies, and currency floats, are too small.

The past year witnessed a string of historic measures undertaken by the leading global central banks who remain frustrated that established governments in Europe and the US cannot solve issues regarding budget deficits, entitlement programs, bank solvency and other social contracts.

The inability of fiscal policymakers to move forward has led to monetary policies that can only extend the time for action. In the final analysis, no central bank can create “real” economic growth. Artificial measures like TARP, TALF, EFSF, LTRO and other acronyms to follow are stop-gap measures. Any politico who claims that current yields and asset valuations on exchanges indicate stability do their constituents a disservice.

In the US, polls and primary election results indicate that voters are aware of the real differences between Main Street, Wall Street and Washington. It is naïve to claim that mortgage rates are at historic lows when there are over 2 million foreclosures a year and key markets in the industrial heartland as well as growth areas like Florida, Nevada and Georgia continue post comps where many homeowners still have mortgages higher than their home value.

The State of the Union is said to be strong. However, Governor Mitch Daniels of Indiana had a far more sobering, and realistic view. The disconnect between politicians who seek to convince the electorate that things are better than most Americans believe is clever, but not sustainable. It remains to be seen if the current holding pattern will extend through election day in November without a serious economic event. Certainly incumbents of both political parties hope so as few expect substantive fiscal policy before then.

The solutions to the issues of the day will not be easy, but at some point central bankers will not be able to support zero. On that day political leaders who were not candid with their constituents will face a sobering rebuke and a new political force will be born.